Governing Financial Stability

A study of the Pre-Crisis Regulatory Regime in the Eurozone

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Any errors or shortcomings remain entirely my own.

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Abbreviations

BAC – Banking Advisory Committee

BBA – British Bankers Association

CAD – Capital Adequacy Directive

CEBS – Committee of European Banking Supervisors

CESR – Committee of European Securities Regulators

CRD – Capital Requirements Directive

ECB – European Central Bank

EEA - European Economic Agreement

EFC – Economic and Financial Committee

EMU – Economic and Monetary Union

EMH – Efficient market hypothesis

EU – European Union

FSC – Financial Service Committee

FSA - Financial Service Authority

FSAP - Financial Services Action Plan

ICCAP - Internal Capital Adequacy Assessment Process

ISD – Investment Service Directive

LIBA – London Investment Bank Association

LOLR – lender of last resort

MiFID - Markets in Financial Instruments Directive

MoU - Memorandum of Understanding

NCB – National Central Banks

OCA – Optimum currency area

OTC – over-the-counter

SGP – Stability and Growth Pact

VaR – Value-at-risk

1 Introduction

1.1 Research question and causal logic

The global financial crisis that began in 2007 and gained momentum in the autumn of 2008 shed light on the consequences of faulty supervision and regulation of the financial sector. The European sovereign debt crisis that followed made it even more obvious. The puzzle that drives this thesis is that as the Economic and Monetary Union (EMU)[1] is crippled by financial distress, institutions seem utterly unprepared. How could this come about? The aim is not to allocate the blame for the crisis. There is plenty of blame to go around. Besides, crisis of this magnitude are mildly put, complex and have many causes and few straightforward explanations. However, claiming that the regulatory regime of the Eurozone is not functioning optimally seems uncontroversial.

Gifted with the power of hindsight the banking and sovereign debt crisis phases have revealed institutional flaws, consequently displaying shortcomings in the EMU regimes crisis prevention and crisis management. The European Commissions own evaluation report on consequences, causes and responses to the economic crisis in Europe share this concern remorsefully:

> *In the light of the developments so far it should also be acknowledged, however, that had a clear EU framework for coordination of financial crisis policies been available beforehand, rather than being set up under extreme time pressure when financial meltdown became a genuine risk, coordinated action could have been implemented sooner and the social cost would have been lower (*European Commission 2009:56*).*

Although interconnected, the crisis in Europe can be divided into a banking and sovereign debt crisis phase. The last years, the banking and the on-going sovereign debt phase have been subject to extensive scrutiny by business analysts, prominent economists and the usual commentators. Although not exhaustive, the proximate causes of the crisis are well documented. The ambition of this study is not to explain the direct causes of the crisis per se, but go behind and examine factors that can explain the regulatory regime that allowed for the crisis to unravel. To clarify: Although, part of the explanation, the ambition of the study is not to illustrate that insufficient or regulation or weak supervision strongly contributed the crisis. This is well established. In stead, the thesis seeks to explain why

[1] The Economic and Monetary Union (EMU) is commonly referred to as the Eurozone or Euro Area. The different labeling will be used interchangeably throughout the thesis.

such insufficient regulation or weak supervision made up the institutional arrangements of the EMU regime. The thesis wish to pursue the following *research question*:

What can explain the EMUs regulatory regimes lack of preparedness for financial crisis?

This study examines causes to why the pre-crisis regulatory regime in the Eurozone seemed so ill prepared for a financial crisis. Or as the title implies: the governing of financial stability. The concept regulatory regime is not unproblematic, and good proxies are needed. What is meant by (lack of) preparedness for a financial crisis is elaborated extensively in chapter 2. Briefly, regulatory regime is here understood as crisis prevention and crisis management. Crisis prevention involves financial regulation and supervision. In the end, regulation and supervision is about politics. Ultimately, my thesis concerns decision-making and policy processes. The EMU policy-making process is a multi-level intergovernmental creature. This complicates, and implies that influence can be asserted through numerous actors and channels.

In answering my research question, three factors are considered important and likely to affect policy-making: ideas, interests and institutions. These perspectives are widely applied by political scientists and have a strong position within the field of political economy (Hall 1997). The thesis identify three causal mechanisms in which ideas, interests and institutions can affect the insufficient development of the crisis prevention and crisis management arrangements in the Eurozone: *selective learning, asymmetrical organization of the interest structure* and *asymmetrical Europeanization of policy issues.* Only a brief introduction is included here, as these mechanisms are presented in depth in the analytical framework.

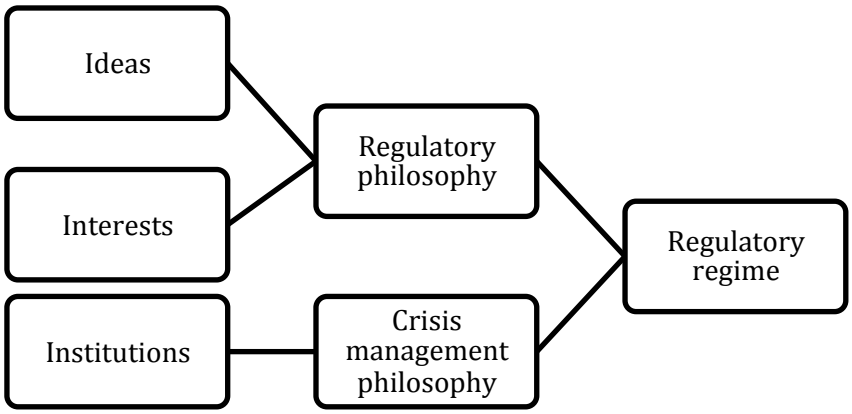
Technocratic committees or expert groups play a key role in policy-making at EMU level, and thus their ideas or "beliefs" about the proper scope, goals and methods on governing financial markets are decisive. *Selective learning* concerns the perception of a certain issue (e.g. financial regulation practices), and how certain problems are emphasised while other are graded irrelevant or overlooked. The emphasis on micro regulation and limited concern for systemic risk by EMU policy-makers and regulators can be example of selective learning.

Asymmetrical organization of the interest structure refers to the technicality of regulation issues and the vast resources of financial lobby groups. This grants interest groups favourable access to the policy-making process and are thus able influence

regulations in line with sector preferences.

The concept of *asymmetrical Europeanization of policy issues* build upon Sharpf (2002) and refers to how national institutional differences affect agreements on pan European policy solutions. It seems that financial integration, granting other member access to domestic markets, is easier to agree upon, than pan European solutions to financial regulation and supervision. For analytical purposes and clarity these explanatory models are presented separately throughout the study. Still, these are not rivalry models, and but must be understood as complementary explanations to a very complex picture. The causal logic of the study is illustrated below (Figure 1).

Figure 1 Causal model



Having presented my research question and causal model, the introduction chapter proceeds as follows. The second section highlights conventional explanations to my research question, before my argument is presented more extensively (1.3). The fourth section emphasise the relevance of this study, allocating its empirical and theoretical context. The structure of the thesis makes up the last section (1.5).

1.2 Conventional wisdom

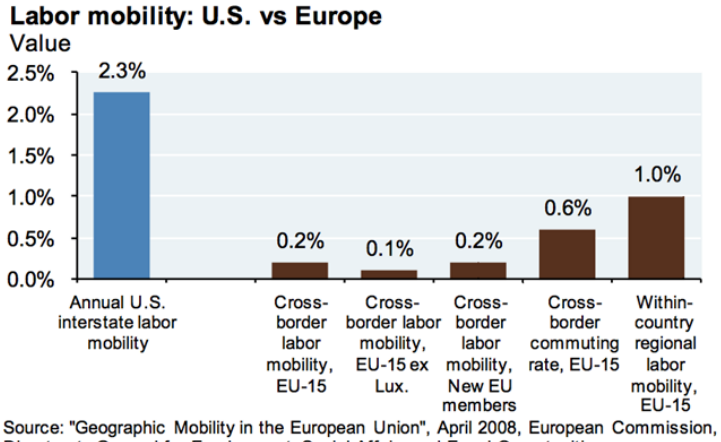
Based on media coverage, the sovereign debt crisis in the Eurozone is often portrayed as a product of financial profligacy in the South. With the possible exception of Greece´ "creative" accounting efforts, this explanation is insufficient. There is undoubtedly some truth to this explanation. Yet, further examination reveals deficiencies with origins in EMUs economic policy framework. These shortcomings are a result of the institutional design of the Eurozone, and have become very visible during the crisis. The "conventional explanation" offered by commentators and scholars describes the heart of the problem in

the Eurozone being; that it is a monetary union, but not a political union, with centralised fiscal powers. Echoing his scepticism from the early 90s (Feldstein 1992), Martin Feldstein (2010) argue that the "the attempt to establish a single currency for sixteen quite different countries was bound to fail".

Scepticism regarding a common currency area was maturing prior to the Maastricht Treaty, and throughout the 1990s a growing body of literature developed (Eichengreen 1990, 1997; Eichengreen & Frieden 1994; Feldstein 1992, 1997; De Grauwe 1997; De Grauwe & Vanhaverbeke 1993; Obstfeld 1998; Bordo & Jonung 1999). Common denominator for the literature was a concern towards pursuing a monetary union in the absence of political unity. A great share of this worry concerned to what extent the EMU fulfilled the criteria's for an optimum currency area (OCA). Based on Robert Mundell´s (1961) seminal paper, OCA is an economic unit composed of countries affected symmetrically by disturbances (shocks) and between which labour and other factors of production can move freely. In a nutshell "when regions or countries are subjected to different disturbances (asymmetrical shocks) the adjustment process will require either real-exchange rates to adjust, or factors of production to move, or a combination of these two. In the absences of real-exchange of flexibility and factor mobility, regional or national concentrations of unemployment will be inevitable" (De Grauwe and Vanhaverbeke 1993:111).

Through the European Central Bank (ECB) and the Single Market - a common monetary policy and free movement of capital and goods - the Eurozone fulfil two of Mundell's criteria's. The case of free labour mobility and a common fiscal policy are not meet. Barry Eichengreen (1990, 1991, 1997) draws on lessons from the US currency union to illustrate some challenges. Eichengreen finds that real exchange rates within EU (E.C. at the time) are more variable than real exchange rates within the U.S. (1991:2). Direct evidence also points to significantly lower labour mobility within Europe than within the U.S. (ibid.). This point is still evident in a later extensive study on EMU performed together with Jeffry Frieden (Eichengreen & Frieden 1994). Another study, by Obstfeld and Peri (1998) supports this assertion and describes the European labour markets as rigid and labour mobility as limited. Recent comparison (CEC 2008) of labour mobility in Europe and the U.S. suggest that attempts to create a flexible labour marked have not been successful.

Table 1 Labor mobility: U.S. vs. Europe



Source: "Geographic Mobility in the European Union", April 2008, European Commission, Directorate General for Employment, Social Affairs and Equal Opportunities.

The most pressing concern is the lack of mechanisms within the Eurozone for fiscal harmonization. Acknowledging that the EMU has no clear historical precedent, many economists use the US currency union as a benchmark when drawing lessons from the history of monetary unions. In the U.S. mechanisms for transfer of fiscal resources from federal government to states was in place only years after the creation of the monetary union (Bordo and Jonung 1999:27-28). According to experiences from the U.S., fiscal federalism plays a decisive role in absorbing regional disturbances (Eichengreen 1997, Bordo and Jonung 1999) and that "a currency union creates pressure for fiscal policy harmonization, effecting both taxes and spending" (Eichengreen 1990:118). This relates to the unfavourable reality of the EMU; that it is a monetary, yet not a political union. A political union with a centralized budget would provide an automatic solidarity mechanism in times of crisis (De Grauwe 2010b). Although such automatic solidarity mechanisms do not solve the adjustment problems of deficit states, it does according to De Grauwe (2010b) "reduce the need for the deficit state or country to borrow in the capital markets...[and] many economists have stressed in the past that such an insurance mechanism is essential for a smooth functioning of the monetary union". One reason that such an insurance mechanism was left out of the Eurozone design was the fear of moral hazard: the risk that high-pressured governments subjected to country-specific asymmetric shocks would be tempted to exploit the existence of an insurance mechanism, and create excessive debts and deficits.

As demonstrated above the Eurozone falls short of fulfilling all of Mundell's criteria's for an OCA. Solutions to overcome labor immobility and create a fiscal union are disparate. Despite policy efforts to boost labor mobility, culture and language obstacles are

likely to persist in Europe. Agreeing upon fiscal policy on the other hand is more a matter of political sensitivity.

1.3 The argument in brief

Not all problems are fiscal. Financial stability was indeed threatened in Greece due to lack of budgetary discipline, however this was not the case in countries like Spain and Ireland. As we shall see later (4.1), these now highly indebted countries kept clear of red numbers and operated within budget limits set out by the Stability and Growth Pact (SGP) prior to the crisis. The Spanish and Irish housing bubbles scenarios demonstrate the importance of effectively prevent non-fiscal risk arising from credit booms and asset price developments.

Financial crisis or financial instability is the result of some form of regulatory failure. Financial regulation is ultimately about politics. Thus explanations to the development of the pre-crisis regulatory regime that failed to prevent the financial crisis can be found in the policy-making process at EMU level.

The thesis finds that the explanations to the EMUs pre-crisis regulatory regime are diverse. First of all, the thesis argues that key documents in the planning and development of the EMU express little or no concern for financial instability and financial bubbles. In stead there seems to be a systematic overestimation over markets ability to self-regulate and belief that through sound government behaviour and budgetary discipline intra-Eurozone stability will prevail. The origin of these ideas can be found in theories of neoclassical economics. Through selective use of economic theory, expert committees, influencing or designing policy, contributed to a biased regulatory philosophy. Emphasising markets and banks ability to evaluate risk, the micro-oriented regulatory regime that developed in the Eurozone failed to properly address rising system-level risk. The dominant belief amongst policy-makers, expressed through the SGP, that government behaviour and public debt was the key threat to stability, overshadowed developments in private markets. This arguably created a lack of attention concerning the accumulation of unsustainable private debt in Europe. Thus, the governing of financial stability in the EMU seems to be suffering from a lack of intellectual preparedness.

Second, the development of the regulatory regime can be explained by the intimacy between policy-makers and regulators and the financial industry. The thesis argues that the distinct character of financial regulation policy-making at EMU level allowed for the financial sector to influence the policy-making process on quite favourable terms. The

technical character of regulatory issues and vast material and human resources of financial lobby groups practically eliminates the traditional counter-lobby parts. This creates an asymmetrical organisation of the interest structure. Between 1999 and 2001 the content of EU regulation considering financial integration underwent large changes (Bieling 2003; Posner & Veron 2010, Quaglia 2010). The "Lamfalussy process" was established for "implementation of a faster and more flexible decision-making procedure in response to accelerated financial market developments" (Bieling 2003: 14). Through this framework, consultation processes between policy-makers and the industry was formalized, thus reinforcing the asymmetry. Skipping traditional lobby steps (gaining access), representatives of the financial sector were invited as "experts" to share knowledge on regulatory issues. Through the status as experts, lobby groups were able to make substantial policy proposals and influence regulatory in line with sector preferences.

At last, explanations to why the regulatory regime seems to be suffering from a lack of preparedness for a financial crisis stems from institutional dynamics. The Euro Area is made up of sixteen member states (since the crisis Estonia has joined) with different institutional economic structures. These varieties give rise to diverging (macro) economic preferences amongst member states: different national financial systems reflect different regulatory preferences. In, turn intergovernmental "battle of systems" (Story and Walter 1997) at EMU level constrains agreements on pan European solutions to regulation and supervision. This provides the regulatory regime in the EMU with insufficient macro prudential policies.

Diverging national economic structures also explain how some policies issues are more sensitive and thus harder to Europeanize (social policies) than other policy domains (market integration). Fritz Sharpf (2002) has described this mechanism as *asymmetrical Europeanization of policy functions.* The thesis apply this logic to explain why the EMU regulatory regime lacked ex ante crisis management routines and burden sharing mechanisms. A burden-sharing mechanism or crisis fund would be based on fiscal transfers from the member states. The thesis argue that the sensitivity of fiscal policy and taxation made it difficult to agree upon a pan-European burdens sharing mechanism in the Eurozone.

1.4 Why this study?

"You are all a lost generation." (Epigraph, *The Sun Also Rises*, Ernest Hemingway)

Fun being part of it, social scientific research should always thrive to make contributions beyond the researchers own interests. The research question must be substantially relevant and the research project should seek to enrich an identifiable research literature (King, Keohane and Verba 1994). A substantial point is made, before the study´s is placed in an empirical and theoretical context.

The substantial relevance of this study almost writes it selves. A single factor – unemployment rate – gives an indication of the severity and social costs of the crisis. In some countries, the future of European youth appears so dark that it is being described in "Hemingwayian" terms as "a lost generation". While writing this (April 2012), the youth employment rate in Spain and Greece is touching 50% (Rogoff 2012). Financial crises are ruthless and the political and social costs are often immense and long lasting. This illustrates the importance of sound and sufficient regulation and supervision of the financial sector. This reason alone makes the Eurozone and financial turmoil of the last years an important field of study.

Empirically, the study complies with two fields of research: studies on the EMU and financial crisis. Already touched upon (1.2), the EMU has been a subject of scrutiny by leading academics for more than two decades. In a same manner there is a vast (and increasing) body of literature on financial crisis. Research on the phenomenon includes both quantitative approaches (e.g. Kaminsky and Reinhart 1999; Reinhart and Rogoff 2009) and qualitative designs (e.g. Galbraith 1955, 1993; Kindleberger 1989, Kindleberger and Abliber 2011). Leading contributions from the likes of Charles Kindleberger and John Kenneth Galbraith focus primarily on the economic causal dynamics behind crisis. Without making invidious comparisons my study complies with this tradition. However, focusing primarily on the political dynamics that shaped the pre-crisis regulatory regime.

The thesis applies theories from the domain of international political economy (IPE). More specifically the emphasis is on the role of ideas, interests and institutions in shaping the EMUs pre-crisis regulatory regime.

The study of ideational factors has a strong and increasing position in IPE (e.g. Hall 1989, 1993; McNamara 1998; Blyth 2002; Beland and Cox 2011). This approach

emphasises the influence of ideas, often operating in "policy paradigms" (Hall 1993), on the development of policies and institutional arrangements. In a European context, previous scholarly research (Quaglia 2009, 2010) states the importance of considering the effect of ideas or "belief systems" when analyzing the politics of financial regulation in the EU. In the wake of the financial crisis, ideational factors have been given increased attention from students of IPE (e.g. Mügge 2011; Baker 2012).

The interest-based approach rooted in the pluralist-tradition (Dahl 1961), emphasis the struggle between different societal actors in shaping the trajectory of the decision-making process. In a European context, (financial) interest groups have been increasingly active in the financial market regulation processes (Mügge 2006, Quaglia 2008b, Posner and Veron 2010). The increasing interaction and blurring roles between public authorities in the EU and the industry makes interest groups an intriguing object for scientific research. This thesis incorporates this approach in order to examine the role financial interest groups play in shaping financial regulation in Europe, and consequently the institutional development of the EMU, and hence the regulatory regime.

1.5 Structure of the study

The structure of the thesis goes a follows. Chapter 2 proposes the theoretical and analytical framework. Here the dynamics of financial crisis is described, before extensive space is given to the operationalization of the dependent variable. The second part of the chapter is devoted to the analytical framework and introduces three explanatory models suited to study the pre-crisis regulatory regime. Chapter 3 elaborates the research design and causal mechanisms, and methodological challenges entailed by the study. To begin with, chapter 4 provides an account of the booming years leading up to the crisis and the state of the Eurozone at impact. Next, the chapter turns to its main objective. The key features of the institutional arrangements for crisis prevention and crisis management are described illustrating the EMU regimes lack of preparedness for financial crisis. The fifth chapter analyses how ideas, interests and institutional dynamics affect the policy-making process in the EMU and, thus the insufficient institutional arrangements for govern financial stability. At last, concluding remarks and theoretical implications of the study make up chapter 6.

2 Theoretical and conceptual framework

The outline of this chapter is threefold. First a brief overview of the dynamics and logic of banking and sovereign debt crises are presented. Next, an extensive section (2.2) is provided for the operationalization of the dependent variable: regulatory regime. Finally, the analytical framework of the study is embellished (2.3). Here the ideas, interests and institutions perspectives (2.3.1-3) are elaborated, and hypotheses are derived.

2.1 The anatomy of banking and sovereign debt crises.

In order to proceed it is unavoidable to cast some light on the dynamics of banking and debt crisis as these are essential to the story. Financial crisis has been a common phenomenon since the birth of capitalism (Reinert 2009). Financial crisis is a broad term touching upon the domains of debt, money, banking and finance. Reinhart and Rogoff (2009:3-14) separates between three main types of financial crisis: monetary and inflation crisis, banking crisis and debt crisis. In my view Europe's financial turmoil is a combination of latter two.

"Countries don't go bust". The words belong to former Citibank Chairman (1967-84) Walter Wriston. This statement is partially true for at least two reasons (Reinhart and Rogoff 2009). First, countries do not usually go out of business and seize to exist. Second, corporate bankruptcy and sovereign bankruptcy are two distinct creatures. Wyplozs clarify one big difference; "a private default is promptly sanctioned according to precise legislation under the control of courts, while public and external debt defaults are followed by litigations and negotiations within fuzzy legal rules and uncertain enforcement mechanisms" (2007:2). This lack of supranational legal framework for enforcing debt contracts across borders is what Reinhart & Rogoff refers to as "perhaps the most fundamental "imperfection" of international capital markets" (2009:53). This aspect affects market expectations and the dynamics of sovereign debt crisis. In 21th century Europe, gunboat diplomacy seems like a highly unlikely method to collect debt and cost-benefit wise irrational. Therefore sovereign lenders are forced to rely on countries willingness (and ability) to repay its debts[2]. Simply put, a sovereign debt crisis is closely linked to the confidence of the market (in a countries solvency status). Debt sustainability is not easily defined (Wyplozs 2007), but closely linked with solvency we are able to formulate an operational definition. Debt solvency is achieved when future primary surpluses will be

[2] See Eaton and Gersovitz (1981) and Bulow and Rogoff (1989a, 1989b) discussions on the "reputation" and "legal" approach on why countries pay back their debts.

large enough to pay back the debt, principal and interest (ibid: 3). The debt burden is commonly measured as debt-to-GDP ratio. The debt stock rises when a government runs a budget deficit or take on private sector debt (e.g. bailing out a bank). This implies that a country´s debt stock can grow forever and still be sustainable as long as it grows in line with the country´s GDP. Hence the sovereign lenders (the market) focus is primarily on two factors; todays and expected future GDP growth rates and todays and future expected government deficits (Baldwin & Gros 2010: 8). As stated, debt crisis are highly interconnected with confidence and market expectations. In the simplest fashion a debt crisis is triggered when investors that previously entrusted a government to be a safe borrower change their perception and decide to relocate their assets. This is when the self-fulfilling negative vortex sets in; as the market perceives a higher risk of default, it raises the interest rates to compensate for the additional risk. Increased interest rates and higher debt-payments contribute to further stress on government budgets making future down payments even more vulnerable. These concerns might again offset even greater expectations of default among investors resulting in even higher interest rates pushing the country towards the edge of sustainability. The high interest rates themselves might produce fear of default, thus issue even higher interest rates.

Banking crisis follow many of the same logics as sovereign debt crisis, however concerning magnitude they can come to differ. Banking crisis can be defined as a banks failure to meet its commitments or be rescued by a lender of last resort. Traditional banking operates by borrowing money short term and lending it out long term. This means that the bank has a substantial amount of it´s money tied up in long-term projects and not able to pay it's short-term funders if they were to collect their money all at once: commonly know as a bank run. The leverage practices of banks make the system even more prone to crisis: for each euro of capital, banks make medium and long-term loans of a dozen euros (ibid). This practice is truly profitable during economic upswings, when short-term funding is easy accessible. Yet again, during economic downturns when short-term funding rapidly dries up, leveraging is very dangerous. In "bubble-spirit", banks and financial institutions borrow too much to invest in – what was believed to be – ever rising asset prices. The result can be excessive debt levels without enough capital in fourth hand. This becomes a problem when prices smooth out or began to fall. Sound financial institutions all at the same time try to reduce leverage. Thereby prices fall even further and solvency problems of banks become a fact. Two dimensions of banking, concerning magnitude, illustrate the

difference between banking and debt crisis.

First, a typical EMU nation holds debt about 60-70% of its GDP; similarly its banks hold liabilities multiple times of that (Baldwin and Gros 2010: Table 2). In 2007, German banks held debt over 300% of Germany's GDP. The same numbers applied for French and Dutch banks, whereas the figures of Irish and Belgian banks were respectively over 700% and 400%. These figures tell us that a systemic banking crisis may bring down not just the banks, but whole nations. Further, the magnitude implies that banks may not be just too-big-to-fail, but also too-big-to-be-saved.

Second, compared to governments, the need for new funding is far more pressing for banks. Baldwin and Gros states that while a typical EMU government needs fresh loans to cover 10% of its outstanding debt *per year*, a typical EMU bank has to seek fresh loans of 10% (or even more) of its total debt on *a daily basis* (2010: 9). Considering the day-to-day need of billions of fresh liquidity loans, a negative vortex (described above) may move dangerously fast. If set in motion, the vortex breeds on fear; slowing down refunding, raising the probability of default, in turn feeding more fear. This relates to liquidity crisis and importance to acknowledge liquidity risk, which will be touched upon below (2.2.2 and 2.2.5).

Having briefly described the logic of banking and sovereign debt crisis, we now turn to the operationalization of the dependent variable.

2.2 Operationalization and conceptualization of dependent variable

The feasibility of this study relies on a solid description of the dependent variable: the regulatory pre-crisis Europe. Regulatory regime understood as; crisis prevention and crisis management. In order to be able to examine the lack of such and draw some inferences we rely on a solid understanding of what we are looking for. Before we proceed the obvious is worth stating. The following sections are written with the great benefit of hindsight. All financial crises are ultimately the result of some sort of regulatory failure. The institutional arrangements for the governing of financial stability in the EMU has, mildly put, been challenged the last couple of years. In the aftermath of the global financial crisis, a range of authoritative reports – the Turner Review, the Larosiére Report, and the Geneva Report – has pointed to a range of shortcomings with present financial regulation and supervision; global and European (FSA 2009, Larosiére 2009, Brunnermeier et al. 2009). Make notice, the purpose of the subsection is not to make a normative judgment on what the regulators

should have known, but more give an account of what issues they prioritised and which they failed to address.

Without elaboration, the dependent variable (regulatory regime) stands out as elusive and good proxies are of the essence. This reflects the length of the remaining subsections. It proceeds as follows. First the hallmarks of two ways of thinking about regulation are briefly presented. Next, being essential to the story, different kinds of financial risk are defined. The following section (2.2.3), conceptualize the main components of the dependent variable; crisis prevention and crisis management. Then, efforts are made to describe variation along the dependent variable, by discussing regulatory issues. Finally, arguments linking the regulatory approach to financial insatiability are presented.

2.2.1 Two regulatory regimes

The Asian Crisis in the late 1990s, promoted extensive debate on the need of a "new financial architecture". In a similar fashion, the current crisis has produced much discussion

Table 2 Two regulatory regimes

Features	Micro	(New) Macro
Instruments	Market discipline	Leverage limits
	Privat risk managment (VaR models)	Countercyclical capital buffers
Regulatory traits		
	VaR models: the route to stability	VaR models insufficient and procyclical
		Wide system perspective.
		Captial requirements sensitive to rare events
	System safeguarded by allowing individual institutions manage risk	
	Financial innovation increases robustness	Include liquidity requirements
Risk assessment	Aggregate risk of individual firms	System-wide risk perspective
	System prone to exogenous risk	System prone to endogenous risk
Supervison	By home country	By host and home country

Source: Author and Baker 2012

about two ways to think about financial regulation and supervision: micro and macro. Above (Table 2) the two regulatory regimes are presented schematically.

The micro-based regulatory regime is characterized by market optimism. Here, risk management and supervisory responsibilities are transferred to the individual institution to ensure financial stability. The foundation of the regime is an individual bank perspective, where the system is kept stable by allowing banks to manage risk on their own. The state of the financial system is determined by the aggregate risk of individual financial institutions. The macro-based line of reasoning is more market pessimistic. This regime emphasises the need to incorporate a system-wide perspective to identify endogenous risk.

After the financial crisis the macro approach seemed the most appropriate. The micro regulatory regime has proven unsatisfactory, and arguably contributed the crisis we have today. Financial regulation is a technical matter, as a political scientist this is not my interest per se; here I shall argue that the regulatory regime played a causal role for the occurrence of a financial crisis.

2.2.2 Four kinds of financial risk

Fundamentally, financial regulation and supervision is about risk. Therefore before we proceed it is necessary to spend a paragraph on different kinds of risks financial institutions face. The following account is by no means exhaustive, but include market-, credit-, operational-, and liquidity risk. Market risk, simply put, involves the inherent risk of dealing in a market where price may change. According to the Basel Committee, market risk is the: "risk of losses in on- and off-balance sheet positions arising from movements in market prices" (BSCS 2005: 1). Credit risk is the probability of loss from a borrower defaulting. It arises whenever a borrower is expected to use future earnings to pay a current debt. This type of risk is important in the day-to-day activity of banks. Credit risk is decisive when setting interest rates. Operational risk can be "defined as the risk of loss resulting from inadequate or failed internal processes, people and systems, or from external events" (BIS 2004: paragraph 644).

Lastly, liquidity risk concerns a banks ability to meet short-term financial demands. A key role of banks is financial intermediation – transforming the maturity of short-term deposits into long-term loans. This function makes banks "inherently susceptible to the risk of that creditors' demands for repayment may outstrip the bank's ability to liquidate its assets" (FSA 2007: 8). The Financial Service Authority defines liquidity risk "as the risk

that a firm, although balance-sheet solvent, cannot maintain or generate sufficient cash resources to meet its payment obligations in full as they fall due, or can only do so at materially disadvantageous terms" (2007: 8).

2.2.3 Crisis prevention and crisis management

Above risk has been defined in abstract terms. Concretely, measures to manage risk include regulation and supervision, and crisis management, if crisis were to occur.

"Crisis prevention", narrowly defined, includes prudential regulation and supervision of the financial sector. Prudential regulation can be understood as a legally binding framework (of rules and standards) for financial institutions with the purpose of fostering financial stability and protect customers of financial services. Prudential supervision compromises the enforcement of the application of rules and standards, and monitoring the activities of a range of financial actors (e.g. banks, securities firms). It "includes on- and off-site monitoring of the safety and soundness of the individual institutions in order to reduce the likelihood of the losses to consumers and investors in the event of insolvency" (Enria and Vesala 2003: 60). The rationale of financial supervision, crudely put, is twofold. One, it seeks to safeguard the stability of the financial system. Second, it is to provide adequate protection to consumers of financial services. The former is emphasised here. Although presented separately here, regulation and supervision are closely intertwined practices and will at times be discussed jointly.

"Crisis management" relates to a range of actions that can be taken by public authorities aimed at easing financial distress, confronting troubled banks and avoiding contagious effects in order to restore the normal functioning of the financial market. These include emergency liquidity assistance, involvement of private (financial) institutions, nationalization of financial institutions or burden-sharing mechanisms. Crisis management operations involve "the cooperation between financial supervisors, central banks, national governments (treasuries) at the national level and across borders…" (Quaglia 2010: 149).

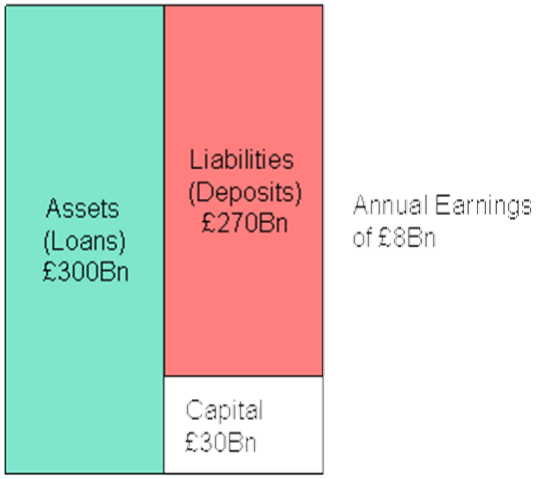
2.2.4 The micro regulatory regime

Above (table 2.1), a schematically and abbreviated presentation of the two regulatory regimes was provided. I now intend to distinguish one from the other, and embellish the micro regimes view on regulatory issues.

A. Views on risk. The micro regulatory philosophy is built on an assumption that risk is truly exogenous. This refers to an idea that financial institutions only face risks from

shocks from outside the system. Such *external* shocks can stem from discrete events (9/11, diseases, worker strikes) and continuous risk (inflation rate, consumer price index changes) (Trkman and McCormak 2009: 249). In contrast, endogenous risk concerns the risk from shocks generated and amplified within the system[3]. The micro approach advocates that it is sufficient to regulate individual banks, and that risk is to be managed through capital adequacy requirements.

The term capital adequacy refers to the "equity and liquidity buffer a bank must have to ensure its ongoing soundness and is measured as a percentage of total bank assets, hence capital adequacy ratio" (Claessens and Underhill 2010: 116f). In short it is the ratio of a banks capital to its risk. Such regulations seek to ensure that banks hold sufficient capital to its assets. For instance, in accordance with the First Pillar of the Basel II Accord, the minimum capital requirements specify that "the capital ratio must be no lower than 8%" (BIS 2004: 12). Very simplified the balance sheet of a (British) bank may look like this (figure 2.1):



In this case, our imaginary Bank XYZ has a capital ratio of 10% (Assets/Capital) and according to the Basel II consensus considered "safe", and able to handle asset losses.

B. Who is best suited to evaluate risk? Risk in is an inherent feature of the financial system. Multiple factors generate uncertainty, and makes it very difficult to attach the (100%) precise risk, and hence the price, to an asset. The micro approach relies on individual

[3] A suited analogy can be found at the casinos, playing roulette and poker. During a game of roulette, you have practically no influence over the outcome, and hence the risk of losing (or chances of winning) stems from outside "shocks". While at the poker table, besides the card you have been dealt, the risk of loosing is affected by you're opponents. A table full of bullies and loose canons generates action, but along with it increased risk.

institutions ability to evaluate risk, and for long regulators have emphasized private risk management. The transfer of responsibility is based on the notion that banks, themselves, possesses the best technology to operationalize risk. Bank and financial institutions risk profiles are based on narrow mathematical models, the "Value-at-Risk" (VaR) model in particular. VaR modelling is meant to enhance banks ability to adequately measure and calculate risk. This is a task of importance since it is closely related to setting of capital adequacy requirements.

If banks, what ever reason, where to mismanage or fail to adequately evaluate risk, the micro approach relies on the market as a "second line of defence." Through disclosure, transparency is meant to enhance market discipline by allowing consumer's insight to the banks risk profile. Banks are meant to issue subordinated debt, in the belief that a transparent market price for bank credit will in it self improve discipline, "either directly through its influence on management behavior, or indirectly by providing information which might trigger intervention by bank regulators" (FSA 2009: 45). Market participants are then able to identify and punish a faltering institution. Hence, following the principle of market discipline is recognition that markets are self-correcting; therefore less supervisory intervention is needed. The functioning of market discipline relies on the fact that people (investors, consumers, stakeholders) posses information on what the banks are doing, what this information means and that are able to act upon the information.

C. Who should perform supervision? To achieve its main objective of financial system stability, the activities of certain financial institutions, banks especially, has for long be supervised. Gradually banking has included transnational activities, thus challenging the role of the traditional supervisor. A division can be made between the "home country"- and "host country"-principle of supervision. As the name suggests, "home country" supervision refers to an arrangement where Bank XYZs operations abroad (host country) are supervised by the authorities in the country it is authorized (home country). "Host country" supervision, naturally, involves the opposite stance: domestic authorities provide financial oversight over both domestic and foreign firms in its jurisdiction. The former approach can be found in the micro- based regulatory regime.

D. Crisis management. As history keeps repeating it selves (Reinhart and Rogoff 2009), financial crisis are likely to reoccur in the future. We might as well be prepared. The principal side with crisis management involves a lender of last resort (LOLR). This concept

concerns the central bank as a provider of emergency liquidity assistance. "The idea" according to Kindleberger and Aliber, "is that a the lender of last resort can and should forestall a run by depositors and other investors from real assets and illiquid financial assets into money by supplying the amount of money that is needed to satisfy the demand…" (2011: 213). One can argue that the essence of the regime described in the previous subsections is so market oriented and so micro based that it neglects the LOLR function. If we take this way of thinking completely out, it is very market based: first line of defense being the banks them selves, the second line of defense is the market and home-country regulation makes up the third line of defense. With this line of reasoning one can imagine that the traditional and historically founded crisis management LOLR is played down. In an extreme form one can argue that it is consistent with a micro regime like this, and not to have a LOLR function.

2.2.5 The argument linking the regime to financial instability

What this thesis seeks to measure along the dependent variable is regulatory philosophy. The previous section established what we are looking for, values on the dependent variable. In order to claim that the micro-based regulatory regime was insufficient to prevent the crisis and even contributed to it, we need to link the philosophy to financial instability. Five arguments will be presented next, to illustrate the micro regulatory regimes lack of preparedness for financial crisis.

First, the regulatory philosophy ignores endogenous risk. Capital requirements have been a key measure for financial regulation – banking in particular. The rationale (Brunnermeier et al. 2009: 14) behind it is that a capital buffers will give banks the ability to absorb losses on its assets and stay solvent (hence, protecting their creditors). This implies that the solvency of individual financial entities ensures the stability of the system as a whole. This represents a fallacy of composition[4]. Risk in a financial system is simply "more than an aggregation of risks in individual institutions; it is also about endogenous risks that arise as a result of the collective behaviour of institutions" (Persuad 2009: 2). It is hard to think of a better example of an environment where individuals react to what is happening around them, but where individual actions drive the realized outcome them, than the financial market. An example to illustrate this, Bank XYZ decision to sell an asset that appears to be risky is surely a prudent response for that individual bank. But as many banks follow, the

[4] Famous example of fallacy of composition: 1. Human cells are invisible to the naked eye. 2. Humans are made up of human cells. 3. Humans are invisible.

price of that asset falls closer to trading limits and banks are forced to sell. Pressure to sell triggers another downward pressure on the asset producing a second selling round, and so on. This process is truly endogenous, as the response is generated within the system. The regulatory regime is even more prone to endogenous risk, due to private risk management.

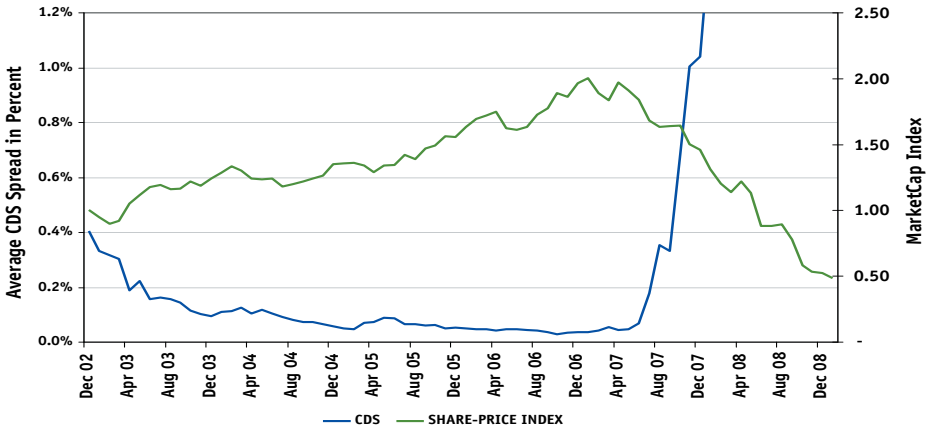
A key feature of this regulatory approach is the reliance on individual banks to manage risk. The belief is that banks possess more up-to-date methodology of risk assessments (VaR models notably) than regulators. Regulation relies on the foundation that each individual bank should seek to perform its own risk management to resemble that of the "best" banks. Hence, if all banks would copy the principles of the best, the system as a whole would be stable and safe (Goodhart 2011: 327). In hindsight, weaknesses with this approach are identifiable. In 2000 already, Persaud observed that large banks' risk assessment models bore close resemblance to one another. VaR models, "operated through daily price sensitive risk limits that required banks to reduce exposure when the probability of losses increased as a result of falling asset prices. This in turn meant that many banks tended to hit their VaR determined risk limits simultaneously and therefore had to sell the same assets at the same time resulting in financial herding and plummeting asset prices further accentuating pro-cyclicality" (2000 in Baker 2012: 5). Pro-cyclicality "refers to how during the up phase of an up cycle, as asset prices rise, measured risk appears to fall" (Baker 2012: 4). Banks that rely on VaR models and, measure risk based on market prices may actually contribute to systemic risk as market participants are encouraged to herd into areas that appear safe. Measured risk can be highly procyclical, because it declines in the build up of booms and inclines in volatile busts (Persaud 2009: 2). Demonstrated in the previous paragraph, fallacy of composition and endogenous risk is inherent in the system. The use of identical VaR models by banks reinforces this effect.

Second, limitations of this regulatory approach concern the underestimation of liquidity risk in private risk management models. The traditional belief assumes that once solvency is under control, liquidity should not pose a problem (Lannoo and Casey 2005: 1). Technological progress, cross-border capital flows and de-regulation of the financial sector would generate higher trading volumes that would enhance the liquidity of assets (and markets alike) (ibid). Specific financial innovations, like securitization, pack and transform illiquid assets (mortgage loans) into liquid ones, tradable in secondary markets. Hence, prior to the crisis there was an increased reliance on "liquidity through marketability": the belief that it was "safe to hold long term to maturity assets funded by short-term liabilities

on the grounds that the assets could be sold rapidly in liquid markets if needed" (FSA 2009: 21). Without elaborating further, through the American subprime-mortgage crisis we now know the dangerous attached to the securitization of debt and mismanagement of liquidity risk. The fall in confidence in one bank, may transform into lack of confidence in other banks. The response of many banks to liquidity problems (e.g. reducing wholesale placing) can in fact strain the liquidity of banks not originally affected (FSA 2009: 52). Subsequently, the collective attempt by many banks to address liquidity issues by selling assets may produce asset price fall and eventually solvency risks. Liquidity issues were in fact one of the original sources of financial distress in mid 2007.

Third, markets did not discipline. In hindsight this is obvious. Thus, this is more of a statement than an argument. Still, some evidence can be provided. The development of credit default swap (CDS)[5] markets was assumed by some to enhance discipline, as it provided a clear external measure of risk (FSA 2009: 45). Lord Adair Turner, chairman of FSA, makes a compelling case of the opposite. Figure 2 below, illustrates that at the eve of the financial crisis, CDS levels failed to address the looming risks in the market.

Figure 2 Composite Time Series of Selected Financial Firms´ CDS and Share Prices



Firms included: Ambac, Aviva, Banco Santander, Barclays, Berkshire Hathaway, Bradford & Bingley, Citigroup, Deutsche Bank, Fortis, HBOS, Lehman Brothers, Merrill Lynch, Morgan Stanley, National Australia Bank, Royal Bank of Scotland and UBS

Source: Turner Review (FSA 2009: 46).

Turner acknowledges moderate success in identifying relative riskiness of different

[5] CDS is a kind of insurance. The purchaser of a CDS pays the seller quarterly fixed fees in return for the promise that the full value of a bond on which the contract is written will be paid off is that bond is defaulted upon (Helleiner 2011: 133). Stirring, is the fact that the purchaser of the CDS does not in fact have to hold the underlying bond. To illustrate, I am able to insure against my neighbors house burning down. For the sake of the argument, this becomes problematic if I have access to my neighbors fuse box, through my brother in law which is an electrician.

institutions (e.g. Northern Rock fotnote). Still, just before the crash in 2007, overall sector wide CDS levels suggested that risks were at historically low, not historically high levels (FSA 2009: 46). One can add to this that bank price shares failed to indicate that risk was rising, "but rather delivered strong market price reinforcement to management's convictions that their aggressive growth strategies were value creative" (ibid).

Prior to the crisis, did agents in the financial market have the necessary information, and will and ability act upon this information? In retrospect, the answer is appears to be no. In line with Turners evidence, a fair conclusion is that market discipline expressed through market prices cannot possess a great role in constraining risk taking by financial institutions. The role of regulators and supervisors should be given primacy.

Fourth, home country supervision is not sufficient. As financial markets become more integrated and transnational capital intensifies, the home country supervision principle is challenged. The principle puts the responsibility of regulation and supervision of Bank XYZs cross-border activity, in the hands of home country supervisors. The host country, in which Bank XYZ operates, is alone responsible for the financial stability of its jurisdiction. Put differently the split work like this: The home supervisor is responsible for the individual bank, whereas the host supervisor is responsible for the system in which the individual bank operates, on in its jurisdiction. A consequence might be that the home supervisor has limited interest or make little effort to monitor the foreign activities of its institutions, Bank XYZ in this case, because it has no responsibility to intervene in case of financial distress in Bank XYZs host country. In normal times, information is likely to flow smoothly, however as financial distress intensifies, the priorities of home supervisors are bound to be domestic. Also, the quality of home country supervision might endanger the stability of host country´s financial system and prove expensive for taxpayers. Depositors or governing authorities in host country might be vulnerable to the failure of Bank XYZ if the home country (of Bank XYZ) lacks the supervisory measures to ensure the solvency of the bank, or fiscal resources to fund a bank rescue.

Host country supervision is not a sufficient condition for awareness of endogenous risk, but it is a necessary condition. Intensified capital flows across borders make banks highly interconnected. To grasp the interdependence between domestic banks and foreign banks in its jurisdiction, host supervisors need enhanced regulatory and supervisory powers.

Fifth, the lack of a clear provision of a LOLR can be costly when financial distress

erupts. Being the ultimate supplier of high-powered money, LOLR is distinguishes it self from other (slower) support operations and crisis management procedures. This is important as it can rapidly provide liquidity to dried up markets in general, or to banks with liquidity problems. Considering that market expectations can change at the speed of fear, the ability to respond quickly to avoid panic is decisive. Second, the *unlimited* capacity of the central bank to provide liquidity assistance is important. Thus, a LOLR is important to restrain financial distress from developing and reaching full-scale financial crisis.

2.3 Analytical framework

Reality is immensely more complex than models, with numerous potential weak links. The failure or insufficiency of the pre-crisis regulatory regime in the Eurozone is likely to be a product of many (interacting) factors. Regulatory arrangements are ultimately a product of policy-making. Three theoretical perspectives on political economy – ideas, interests and institutions – are useful to analyze decision-making processes (Hall 1997). These are applied with the ambitious goal to identify what cause(s) can explain why the pre-crisis regulatory regime in the Eurozone. Before we proceed, two clarifications regarding the independent variables are necessary.

First, a clear distinction between dependent variable and the ideational variable is needed. The dependent variable, regulatory regime, concerns more practical dimensions: what regulations and supervisory arrangements are present. The ideational variable, regulatory philosophy, is more abstract, and is almost conflatable with economic theory. In this regard, the regulatory philosophy concerns the regulatory regime´s understanding of the functioning of the economy.

Second, the purpose of this thesis is not theory testing per se. The hypotheses set out below are mainly meant to reflect the theoretical perspectives and guide the empirical research and the analysis in chapter 5.

2.3.1 Ideas

Yet very frequently the "world images" that have been created by "ideas" have, like switchmen, determined the tracks along which action has been pushed by the dynamics of interest (Max Weber 1946:280).

Ideas are important, and have been given causal priority within social science for some time – illustrated by Weber´s famous "switchmen of history"-metaphor above. Imagine the opposite. If ideas did not matter; school boards and committees would stop fighting over

curriculums, the publication of The Satanic Verses would pass in silence, the treasures of the Enlightenment would be irrelevant, consultant agencies would be out of business. As political sociologist Jal Metha (2011) puts it: it is not a question of *whether*, but *how* ideas matter.

We live in a chaotic world. Human decisions are taken under uncertainty (Knight 1921; Tversky & Kahneman 1982). As intuition tends to trump reasoning, we make hasty and often faulty decisions (Kahneman 2011). Our reduced perception and limited capacity to process a large amount of information makes it difficult to navigate in such a complex reality (e.g. the financial system). We therefore rely on ideas to organize our interests. In technical and highly complex policy areas such as financial regulation, one can argue that the interest of policy-makers and stakeholders are not as self-evident and they need to be defined (Quaglia 2010:17). *Policy paradigms* may provide the lenses to do so. Constituting "a shared body of causal ideas concerning a certain policy area" (ibid.), a policy paradigm describes the way in which politicians and bureaucrats communicate, how policy is shaped and what instruments are seen as applicable to the problems identified (Hall 1993). In his study on market regulation, Vogel (1996: 20) emphasise the importance of ideas or "regime orientation", defined as "state actors' beliefs about the proper scope, goals, and methods of government intervention in the economy, and about how this intervention affects economic performance". This thesis, support Vogel´s definition, although "regulatory philosophy" will be used extensively to avoid confusion with the dependent variable (regulatory regime). Beland and Cox goes as far as to say that ideas constitute a primary source of political behaviour; "ideas shape how we understand political problems, give definition to our goals and strategies, and are the currency we use to communicate about politics" (2011:3). A general acceptation worth mentioning is that "ideas do not have any impact by themselves…(but) influence politics only by acting through or on a particular political actor" (Berman 1998: 22).

In his study of Keynesian politics, Peter Gourevitch (1989) states the obvious and unfortunate reality; "good ideas do not always win". To transform into policy, "ideas must link up with politics – the mobilization of consent for policy" (ibid: 88). Given the power aspect of politics, even a great idea cannot become policy if it encounters strong opposition. In the same manner a poor idea can become policy if it is able to generate a certain degree of support. As established above, ideas are important. However, they are filtered. Some come to dominate policy while other perish or are left out in the cold.

Building upon Hall´s (1993) concept of "social learning", Tranøy (2000) has developed the term "selective learning" which is a useful supplement. The term is "meant to cover situations where there is ignorance about, or insufficient understanding of, functional interdependencies between issue areas" (ibid: 75). What policy that is eventually "learned" is determined by a range of factors; previous policy itself is argued to be strong on learning; the states capacity to "act autonomously from societal pressure" (Hall 1993: 278); and "epistemic communities" (Haas 1992) that posses a great deal of power to influence the policymaking of political elites.

I wish to combine the concept of "selective learning" with an "economist-centered approach" (Hall 1989: 8). There is a broad literature that emphasises the role of professional economists and stresses the impact of expert advice on policy (see e.g. Nelson 1987). Paraphrasing the work of Hugo Heclo: "Politics finds its sources not only in power, but also in uncertainty – men collectively wondering what to do....Governments not only "power"… they also puzzle" (cited in Hall 1993: 275). In these times of uncertainty politicians often turn to networks of knowledge-based expert for much needed advice. In the case of economic policymaking, the answers to the "puzzlement" are often found in certain economic theory with a strong position within the ruling epistemic community. Hence, there is a close relationship between the hegemonic economic theory and the financial regulation practices of policy makers.

Paradigms are in short a certain way of interpreting reality. Unfortunately the interpretation can prove both ignorant and insufficient. A dominant economic policy paradigm within a policy field can seldom explain everything within that particular field. At any given time certain events will challenge the scope of the theory. These events are rationalized as abnormalities or irregularities, and even to the extreme referred to as "Black Swan" incidents: events so highly improbable that they are categorized as "unpredictable" (Taleb 2007). A more accurate description of these events are that they are incomprehensible according to *that* paradigm. For instance, according to the Australian economist Steve Keen the financial crisis of 2008 was not unpredictable: the only question mark was over when it would occur, not if. "Rather than being a "Black Swan", the Great Recession was a "White Swan" made invisible to neoclassical economists because their theory makes them ignore the key factors that caused it: debt, disequilibrium, and time" (2011: 1). The fact that certain economic theory manages to achieve hegemonic status amongst policy makers, might imply that policy makers are equipped with weak and insufficient toolboxes: making

them intellectually unprepared for certain issue areas. This might be the case prior to the financial and sovereign debt crisis in Europe. The following sections will present two prominent, but contrasting theories on the functioning of the financial economy: the efficient market theory and the financial instability hypothesis.

The efficient market hypothesis

Conventional economic theory states that the market, if allowed to operate freely, will provide us with the most effective resource allocation. In an efficient market, the interaction of supply and demand – buyers and sellers – determine price and quantity, thereby creating equilibrium. In the state of equilibrium, price and quantity is stabilized, and there is no reason for neither producers nor consumers to change their behaviour. The theory of supply and demand is also held to apply to factors of production such as labour or land or capital (Stilwell 2009: 154). If financial and capital markets follow the same dynamics a competitive financial market would provide us with a stable equilibrium where resources are effective allocated. In the 1960s this notion was developed further and the notion of efficient markets grew strong among dominant economists. The publications by Chicago economist Eugene Fama (1965, 1970) stands out as key papers on the efficient market hypothesis (EMH). This theory tradition believes that the price of any given asset at any time always reflects available information and thereby "correct": an asset cannot be overvalued or undervalued. When supply and demand changes, there is a price signal that provides information and the actor changes its preferences. In financial markets information flows freely and rational actors are able to process and act upon this information. This implies that the financial market is merely a reflection of the real economy. Hence, in neoclassic economics, finance becomes irrelevant as it just an infrastructure service that mirror the activity in the real economy and therefore cannot be a source of instability. Following this reasoning means that markets do not create instability – bubbles and busts – since the unregulated market is self-stabilizing.

This dominant belief and confidence in markets abilities to stabilize it self has been under sharp critique from prominent scholars, who emphasise the systems as inherently unstable, finance being the driver (Minsky 1986; Shleifer 2000; Shiller 2005).

Financial instability hypothesis

Liberalising markets have known advantages. Free flow of capital and a common currency reduced transaction costs and stimulated trade: In sum, economic growth for many EU

countries. However there are some disadvantages. Scholars from the field of history, political science and economics argue that a market-oriented system of financial integration with a high degree of capital mobility is inherently unstable (Kindleberger 1989, Strange 1996, Minsky 1986). Recent empirical studies support this assertion. Kaminsky and Reinhart (1999) study of twenty-six financial crises since 1970 show that eighteen of these crises took place only few years after the liberalization of the financial markets (1999: 478). Reinhart and Reinhart (2008) indicate a relationship between considerable capital flows into a country and the increased risk of a financial crisis. Studying 54 countries in the period 1980-95, Demirgüc-Kunt and Detragiache (1998) finds an empirical relationship between banking crisis and financial liberalization. Some goes as far as claiming that there is "no real-time historical case of successful economic development under conditions of financial openness" (Underhill 2011: 114).

Influenced by Keynes (1936), the seminal work of economist Hyman P. Minsky (1986) is a great departure in order to grasp the inherent instability of the financial system. In contrast to neoclassical theory, which ignores finance, as the financial sector is treated merely as a reflection of the real economy, Minsky places finance at the centre of economic analysis for the simple reason that capitalistic economies are run by banks (Galbraith 2010). Minsky argued that equilibrium itself was inherently unstable. "The major flaw of our type of economy is that it is unstable. [...] Instability is due to the internal processes of our type of economy" (Minsky 1986:11) Minsky offers a model for financial crisis that present a useful overview of the development of financial crisis.[6] In the model the process that leads up to the crisis starts with a "displacement": an event that creates new profit-opportunities within parts of the economy. The event can be financial or technological innovations that changes the perception of risk or preferences or political decisions like financial integration or deregulation of the banking sector. However this "displacement" leads to an increase of confidence and optimism spread among investors. Minsky emphasises the importance of actors behaviour in times of prosperity, especially when euphoria kicks in. Firms and households seize to exploit this profit-opportunity and increased investments creates economic growth. The financing of this phase is characterized by what Minsky calls *hedge-financing;* the expected return of investments are enough to cover interests and repayment with some margin. The economic "boom" is reinforced through the expansion of credit and new investments, and expectations of further growth. According to Minsky financing

[6] Based on Minsky (1982, 1986) and Kindleberger (1989:chapter 2)

changes character to *speculative-financing;* now expected return of investments only cover interests and not repayment on the actual loan. Investors are now forced to restructure parts of their debt, therefore more vulnerable. Additional loans from financial institutions increases the amount of credit within the system, and produces an investment climate blinded by (almost) unrealistic expectations of further growth. The amount of risk undertaken reaches new levels, and the inherently non-sustainable-doomed-to-fail *ponzi-financing* position is a fact. Now the expected return on investments falls short of covering both interests and repayments. The investor is forced to undertake new loans just to cover the interests on existing loans. The ponzi position marks the end of the pyramid game in the banking system, and the banks withdraw liquidity. As customers realize the systemic risk they start to withdraw money from the banks (Minksy moment). A certain panic evolves, and more frequent "bank runs" forces upon a state of crisis.

According to Minsky the "tendency to transform doing well into speculative invest boom is the basic instability in a capitalist economy" (1982: 67). Hence, his classic phrase that "Stability…is destabilizing" (ibid: 101). Out of the two contrasting views on the functioning of the financial economy, it seems that it is the former that has gained most influence amongst policy makers in Europe.

In her well-cited study, McNamara (1998) demonstrates how a "neo-liberal consensus" on monetary co-operation spread across Europe in the mid 70s[7]. McNamara makes a compelling argument that the policy shift must be understood as one of political choice. She argues that neither globalization theory (capital mobility) nor private interests of economic actors can fully explain the strengthening of the neo-liberal consensus as there where other policy options (e.g. the U.S. and Japan moved away from fixed exchange rates in the same time period). The fact that monetarism was accepted then although the theories had been around since the 1930s convincingly guides McNamara to assign political actors explanatory power. The consensus was fully developed once the European economic elite (government officials and central bankers) "adopted these ideas as their political template" (ibid.).

[7] McNamara (1998) argue that the foundation for change was a mash-up between the failure of Keynesian policy to address the first oil crisis sufficiently, the appeal of anti-inflationary monetarist theory, and German success under monetarism "By defining the problem, providing an alternative solution, and demonstrating the policy´s effectiveness, these three sources of neoliberal change promoted and legitimated a convergence in policy preference among European elites" (1998: 6).

Selective learning concerns the perception regarding a certain issue (e.g. financial regulation practices), and how certain problems become centre of attention and other are graded irrelevant or overlooked. Here, the "selective" component refers to a lack of understanding of functional relationships. This may cause decisions making based no insufficient understanding of the consequences of dis-coordination of institutions or policies. For instance, as financial markets become highly integrated across borders, micro regulation and supervision is insufficient. The supplement of macro approach is needed. As a set of ideas become dominant within a policy field they can function as tools to structure and limit political decision making by defining what aspects of an issue are troublesome and attention worthy, and what aspects are to be left out in the cold. Acknowledging the influence of ideas, demonstrated above, and accepting the premise that professional economist have great impact on policy-making I expect to find ideas present in policy documents on EMU level. I wish to test the hypothesis that the dominant regulatory philosophy within the EMU confined to neoclassical tenets – belief in self-correcting markets, rational actors, minimal government intervention, little concern for private debt – subsequently made the EMU regime ill prepared for financial distress. In abstract form the hypothesis can be formulated as follows: *Through selective learning, expert committees produced a biased regulatory philosophy that created an insufficient EMU regulatory regime.* In operationalized terms the hypothesis goes as follows:

Hypothesis I: In policy documents concerning the planning and development of the EMU there is a systemic overestimation of the markets ability to preserve stability and a systemic underestimation of financial instability and the accumulation of private debt.

2.3.2 Interests

Everyone has economic interests, and "what people want depends on where they sit" (Gourevitch 1986: 56) in some kind of structure. Interest-based approaches within IPE are concerned with power relations. Whose interests are being taken care of by any given set of economic arrangements and how do these arrangements distribute power and resources across social groups? (Hall 1997: 175). How large corporations and interest groups exercise power in order to shape the trajectory of decision-making within the western political sphere is a crucial yet understudied theme. Close ties between interest groups and government officials have often been associated with developing countries. The though that powerful economic elites has exercised influence within the political systems of western democracies has simply surpassed our imagination (Johnson & Kwak 2010: 53). "Capture"

theory "emphasizes the role of interest groups in the formation of public policy" (Laffont & Tirole 1991: 1089). According to Johnson and Kwak the core problem in regulation is whether the regulators will enforce rules that harm the interests of the particular industry they oversee, or whether they themselves will be "captured" by that industry (2010:93). An important point to be made is that capture does not imply that the regulators are corrupt, or for that matter that their actions mirror personal interests. On the contrary, "regulatory capture is most effective when regulators share the worldview and preferences of the industry they supervise" (ibid).

On one hand, "banking is one of the most regulated and supervised of economic sectors" (Hardy 2006: 3). On the other, there is no reason to believe that the financial sector is immune from regulatory capture; actually some of the features of the sector makes it especially prone to it. Compared to other policy areas the regulatory dynamics in finance and banking differ quite strongly. Technical complexity and asymmetrical interest-structure are two key features of financial regulation, with the latter partly being an effect of the former (Hjertaker and Tranøy 2011). The technical component shapes the regulatory environment in at least two ways. First, technical issues – concerning banks capital requirements or risk assessment methodology– are for obvious reasons less appealing to the electorate than issues concerning health care or taxation. This leaves more room for powerful interest groups to influence regulation outside the spotlight of the media or election campaigns. However, with ambiguous effect, the recent revolts of the Occupy Wall Street movement demonstrate an increasing popular interest in the regulation of the financial sector. Secondly, as stated, issues concerning financial regulation are complex, technical matters. Causal relationships that regulatory policies spring out of, are rarely intelligible for consumers, third parties and non-economists. Both these aspects favour experts and well-organized interest groups and to a great extent contribute a asymmetrical organization of the interest structure of the sector. The involvement of consumer organisations is not only confined by limited resources (capital, expertise), but also by "collective action problems" (Olson 1965). Consumers of financial services would benefit both individually and collectively by certain financial regulations, however incentives to organize, invest resources and lobby for those interest are limited as the individually benefits of those regulations would be diffuse (Quaglia 2010: 146). Whereas a single regulation measure may not have much affect on the average consumer or small investor, certain rules may be costly for providers of financial services. As regulation and supervision produces both costs and benefit for financial associations, they have incentives

to try to influence the policy making process through lobby activities. Activities, large financial associations have considerable resources (compared with consumer organisations) to engage in.

Hardy (2006: 5-6) emphasise the effect of regulators and regulates meeting on a regular basis. Regulators often consult with the industry before modifying changing legislation (in some instances they are legally required to do so). Here, the technical complexity of financial regulation dimension plays in. EU and national officials simply lack the expertise or knowledge on some issues. For instance, the European Commission lacks the expertise to manage complex financial products and consult the industry on several issues (Stichele 2008: 40). The fact that bankers and supervisors often converse during on- and off-site inspections endow the bankers the opportunity to promote their views and interests to regulators and supervisors.

Financial institutions also tend to have well-established connections to the political establishment to exercise influence (Johnson and Kwak 2010). In the United States, for instance, financial institutions are among the biggest contributors to political campaigns (Hardy 2006: 4).

The involvement of the industry in financial regulation is increasing worldwide (Porter 2005, Johnson and Kwak 2010). Some scholars (Underhill and Zhang 2010) argue that the architecture of global financial integration has strengthened the position of (relatively unaccountable) private market actors. Financial globalisation has changed the balance of power between public authorities and private interests, allowing private actors to participate in a "narrow and a relatively closed policy community, a situation approximating policy capture" (ibid: 292).

Do issues concerning regulatory capture apply to EU politics? A vast body of literature on interest groups and lobbying in EU (e.g. Bouwen 2002; Dür 2009; Coen and Richardson 2009a; Greenwood 2011) justify such a concern. It is universally accepted that there has been a huge increase in EU lobbying over the past to decades (Coen and Richardson 2009b: 3). Although estimates have been subject to variation, the number of interest groups at EU level has increased sharply since the mid 1980s and onwards (Greenwood 2011: 12-3). Methodological concerns with measuring taken into consideration (Dür 2008, 2009), several studies support the assertion that lobby groups have significant influence on a range of EU policy areas: trade (Woll 2009), health (Greer 2009), food (Grant and Stocker 2009), and financial services (Quaglia 2010), to mention a

few. There is a general acceptance that lobbying by the financial industry is the most influential considering its vast amount of resources to undertake own lobbying activities and participation in official consultation processes at EU level (Stichele 2008: 39). In addition there is no reason to believe that the features of financial regulation described above (technical complexity and asymmetrical interest structure) to be invalid for EU circumstances.

Why regulatory capture of the financial sector is an issue of great concern almost goes without saying. First, there is reason to believe that there is a dissonance between the interest of bankers and the average European. Second, the systemic effects of a banking crisis have severe consequences for society as a whole. The scale and magnitude of the global financial crisis and the present sovereign debt crisis is living evidence for many. The degree of interconnectedness in banking and finance in Europe exposes the need for macro prudential regulation: rules and requirements that could have made EMU more prepared for financial crisis. Based on the asymmetrical interest structure of financial regulation, strong interest may have successfully opposed or mitigated rules and regulations that could have made the EMU better equipped for a financial crisis. From this the following hypothesis is derived:

Hypothesis II: An asymmetrical organization of interest structure enabled the financial industry to mitigate prudential regulations that could have guarded the EMU against and prepared the EMU better for, a financial crisis.

2.3.3 Institutions

The Eurozone is not a homogenous entity. It is made up of sixteen member states[8] with different history, culture, political institutions and economic structures. These institutional differences give the Eurozone an intergovernmental dimension, which in turn reflect diverging policy preferences amongst member states. This can explain why some policy issues are easier to agree upon and "Europeanise", than others. An institutional approach may prove helpful to clarify how economies are organized and explain, "how such configurations impact agents´ interests" (Blyth 2009: 197). In a political economy context, they can be viewed as, "the formal rules, compliance procedures, and standard operating practices that structure the relationship between individuals in various units of the polity and the economy" (Hall 1986: 19). One major strength of this approach, according to Hall,

[8] Since the financial crisis erupted, Estonia has joined, making it seventeen.

is that it moves "beyond the tendency of conventional economic analysis to treat all developed economies as if they where institutionally identical" (1997: 182). This may help account for why similarly placed agents in similar structural positions do not in fact act the same way across cases (Blyth 2009: 209). This relates to the query of this thesis: as it may help explain why European governments have acted differently both pre- and post-crisis.

The absence of ex ante crisis management routines and burden sharing agreements could indicate a lack of institutional capacity (and an intellectual preparedness) for financial crisis. The awareness of issue areas varies. Some issue areas one where blind to, other issue areas where well known, but not possible come around. Fiscal policy was such a well known issue area. Fundamental problems with running monetary union without fiscal union were well documented (1.2) prior to the introduction of the euro. Through the SGP, European leaders where able to agree upon some surveillance of budgets and debt limits. An agreement on common European taxation – which could strengthen a crisis fund and be used for transfers – on the contrary has been incomplete. One explanation could be that different policy areas are subject to different institutional dynamics. Hence, some policy areas are "stickier" than others. In the European case, policies favouring market integration seems to have been less sticky and more political feasible than social polices (e.g. taxation).

Fritz Sharpf (2002: 645) argue that; "European integration has created a constitutional asymmetry between policies promoting market efficiencies and policies promoting social protection and equality". This asymmetry follows from the "selective Europeanization of policy functions" (ibid: 647). Concerns regarding market or monetary policies tend to trump social policies because they are settled at the European level (less sticky). According to Scharpf, the diverging development of welfare state institutions and policies from the 50s to the 70s also explain the struggle to "Europeanize" social policy. Dividing along Esping-Andersens (1990) "three worlds of welfare capitalism", Sharpf argue that the diversity of social-protection systems between the likes of Denmark, Britain and "continental" (original six) countries and "the political salience of these differences make it practically impossible for them to agree on common European solutions" (2002: 652). Arguably the same logic can be applied to crisis prevention and crisis management. Policies in the realm of market integration and monetary cooperation has been strongly Europeanised, as oppose to financial regulation and supervision, which mainly remains at the national level. In a similar fashion, it seems that its is easier to open up the markets than agreeing on clear division of responsibilities and *ex ante* crisis management procedures and

burden sharing routines if a financial crisis was to unfold. From this I derive the following hypothesis.

Hypothesis III: Varieties of national financial systems constrained agreements on pan-European arrangements for financial regulation and supervision, that could have made the EMU better prepared for a financial crisis.

Hypothesis IV: National institutional diversity can explain the lack of crisis management procedures and burden sharing routines.

3.0 Methodology

Having accounted for the theoretical and conceptual framework, the method of inquiry will be presented next. The chapter proceed as follows. First the goal of the research is addressed. Next the research design is presented and the causal logic of the thesis and methodological challenges are embellished. Finally (3.4), some reflections on the use of sources are highlighted,

3.1 Goal of the research

The ambitious goal is to identify some cause(s) that can explain the EMUs lack of preparedness for financial crises. As mentioned earlier (1.4), there is a broad literature on financial crisis, including both large-N comparisons of crises (Reinhart and Rogoff 2009) and in depth historical analysis with qualitative design traits (Galbraith 1955, Kindleberger 1989, Kindleberger and Aliber 2011). My work complies with the latter tradition, and seeks to explore the influence of ideas, interests and institutional dynamics on EMU policy making; both in the planning and construction of the EMU and the extensive integration of the financial markets in the early 2000s. In short, my goal is to draw some inferences on how different causal mechanisms affected the developing of institutional arrangements for governing financial stability in the EMU. Arrangements that left the EMU ill prepared for a financial crisis.

3.2 Research design

In its broadest sense, the thesis is a case study of Eurozone governance: the link between financial instability and political (and economic) governance. Hence the empirical and causal ambitious are mildly put complex, considering that the object of study include a range of policy fields and involves a broad actor scheme. To answer my research question I adopt a "structured and focused" approach (George and Bennett 2005: 63-75). It is "structured" in the sense that the thesis is organized as a three-folded analysis, focusing separately on expert committees (ideas), financial industry (interests) and institutional dynamics. The "focused" character of the study is that it "deals only with certain aspects of the historical cases examined" (ibid.). In both cases the foundation for the analysis is key documents and selected key actors. As the study emphasises the role of interest and expert group, key actors involve the largest lobby organisations, and committees and high ranking working groups. An account for the selection of cases and actors is presented below (3.2-3.3).

Case study as a research strategy is well suited when concerned with decision-making (Yin 2003: 12). Through in-depth analysis of the policy-making processes, case studies are suitable for examining causal mechanisms. This implies that my study is more concerned with internal than external validity. According to Gerring (2007: 43) external validity refers to the ability to generalize the findings to an unstudied population. Although the research design favours internal validity, understood as establishing causal relationship, generalisations are not ruled out. In a wide-sense, my work can be interpreted as a "building block" study (George and Bennett 2005: 76). When compared to other studies of the same phenomenon under inquiry, common patters may become visible implying contextual generalizations. For instance, previous research show how ideational factors and interest groups can play a crucial role in policy-making of financial regulation. Studies of the Basel II policy-making process demonstrate how ideas and the financial sector influenced the beliefs of policy-makers, implying a regulatory capture (e.g. Claessness and Underhill 2011; Tsingou 2009). Thus causal mechanisms identified in this study are not necessary unique to this case. The following section will clarify the causal logic of this study and methodological challenges.

3.3 Causal mechanisms and methodological challenges

The introduction gave an overview of the "causal logic" of the thesis (Figure 1.1). It is desirable to specify further. According to Elster causal explanations must be separated from true causal statements. "To cite the cause is not enough: the causal mechanism must also be provided, or at least suggested" (1989: 4). Based on the analytical framework (2.3), my assumed casual interactions can be presented in a three-fold causal model. These will be accounted for next, while discussing methodological challenges entailed by the study.

Ideas – The discussion in subsection 2.3.1 established the role of ideas as a powerful tool for policy-makers to communicate, and emphasised (economic) expert committees as providers of ideas and ultimately key actors in shaping financial regulation policy. The causal interaction in which ideas influence regulatory policy goes as follows:

Selective learning (see 2.3.1) relates to which regulatory issues are perceived as important by experts, and ultimately communicated to and "learned" by policy makers. Economic theory (step 1 in causal chain) is characterized by pluralism. Besides dominant ideas rooted in neoclassical theory, there is also a heterodox tradition within economics. The macro-oriented work of Minsky (1982, 1986) presented above (2.3.1) represents this latter tradition, and is compatible with progress on more micro-funded thinking with basis in cognitive psychology: for instance, the rise of behavioural finance (e.g. Shleifer 2000; Shiller 2005). Through the expert committees and selective learning only the substance of one tradition is communicated further, thus creating a monoculture in regulatory philosophy (step 4). Therefor, I aspect to find only certain economic ideas, relating to the functioning of markets and financial regulation, present in policy documents and the regulatory regime.

Given their unobservable nature, the study of ideas is not unproblematic. Béland & Cox argues that "we know ideas are essential when we can identify an idea and trace its influence on a particular political outcome" (2011: 13). The construction of ideal types can be a helpful tool when tracing and organising ideas. Based on secondary literature and previous discussion (2.3.1), two conflicting views concerning the functioning of (financial) markets may look like this:

Assumptions/ideals	Efficient market hypothesis based	Financial instability hypothesis based
Markets	- Self-regulating (equilibrium)	- Inherently unstable (frequent disequilibrium)
Actors	- Rational	- Prone to collective euphoria
Information	- Complete	- Asymmetrically distributed
Risk to the economy	- Exogenous	- Endogenous

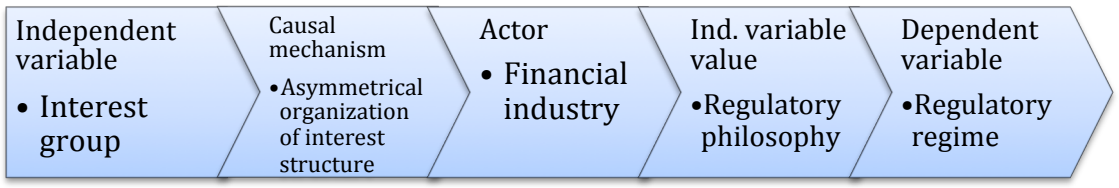
The two "ideal" types are by no means exhaustive, as they are truly meant for guidance. If too detailed, ideal types might function as a straitjacket on the text under examination. At the same time, if the ideal types do not seek precision, we are left with preliminary sorting. Ideas on functional economic relationships can seldom be found expressed in policy documents in the same explicit manner it is presented in the academic literature where it origins. Hence, tracing ideas involves the task of "reading between the lines". This leaves room for interpretation from the researcher, and presupposes extensive knowledge on the

topic of study. This can have implications for the reliability of the study.

The fact that an idea is not found in policy documents does not necessary mean it was not considered important at the time. From time to time some ideas or policy paradigms reach the level of "zeitgeist": a "set of cultural, social or economic assumptions that are overwhelmingly dominant in public discourse at a given moment in time" (Mehta 2011: 40). It is therefor important to rise above the text and examine the context in which the policy document is produced.

With the increasing Europeanization of policy issues, the EU bureaucracy is growing rapidly. Along with that numerous technocratic committees and complementary expert groups have been established. The thesis is somewhat strategic in its focus on expert groups. The work of The Economic and Financial Committee (EFC) and its successor of the EC Monetary Committee will be emphasised throughout the thesis. The EFC prepare the work of the Euro Group and lays the ground for decision-making within the ECOFIN, it is said to have "strong influence on sensitive aspects of problem-solving in European macroeconomic policymaking" (Umbach and Wessles 2008: 60). Its members are selected "among experts possessing outstanding competence in the economic and financial field" (Dyson and Quaglia 2010a: 765). Other key committees emphasised include: the Banking Advisory Committee (BAC), the Committee of European Banking Supervision (CEBS), the Committee of European Securities Regulators (CESR), the Financial Services Committee (FSC).

Interests – Measurement and conceptualization of interest group influence is no easy task. Grasping what is being said behind closed doors in Brussels borders to the impossible, at least for a graduate student. Many research topics in social science stand out as intangible. However, the fact that a phenomenon is hard to study does not make it any less important as a research topic. Studying interest group influence in the EU is obviously difficult, yet the issue is too important to be neglected. Based on the theoretical discussion in section 2.3.2, the causal interaction between interest groups and regulatory policy may look like this:



The technicality of financial regulation issues and (financial) lobby groups' vast amount of resources creates an asymmetrical organization of the interest structure (causal mechanism). As "experts" (step 3) on the field and with no traditional counter-lobby part the financial industry is granted access to the policy-making process on mildly put, favourable terms. The degree of intimacy between the financial industry and regulators can function as a good, however not complete, indicator of lobby influence.

An important precondition for the study of interest group influence is a usable description of what is meant by influence. Several studies dodge a definition emphasising the *access* (Bouwen 2002) of lobby groups. Although institutional structures matter and will be weighted, access through formal consultations and participation is not synonymous with real influence. The lack of an agreed definition of the term has according to Andreas Dür been an "obstacle crippling research on interest group power and influence…" (2009: 1220). Power has been a highly contested concept in field of political science, accumulating in the "faces of power" debate in the 1960s and 1970s. In its most direct form, power ("first face") is described as: A´s ability to get B to do something that B otherwise would not do (Dahl 1957: 202). This thesis, in line with Michalowitz (2007: 134), understands lobby influence as a weaker form of power. The actor (policy-makers or regulator) is being *persuaded* to pursue a certain course of action, even if they initially did not wish or intended to do so. Influence is therefore understood as an actor's ability to shape a decision in line with its own preferences.

Defining the preferences of interest group actors is an even trickier task. Even when we know a groups "stated objective and policy outcome, we may still not have enough information for correct coding" (Mahoney 2007: 37). Ideally, interviews with bank representatives or lobbyists could have provided clear-cut preferences on a certain legislative proposal (e.g. MiFID, CRD). On the contrary, such sources must be treated cautiously as interest groups may have strategic incentives to misguide by over- or underestimating their interests in the specific legislation (Dür 2008: 568). This is one of the shortcomings of this research design as no interviews, due to practical concerns, have been conducted. This thesis shares others (Quaglia 2010: 21) assumptions that "policy preferences are determined by conventional interest-based political economy considerations": in this case the adjustment costs (or benefits) to and competitive implications of EU banking and financial services regulation on financial institutions. Banks have capital requirements on their equity (or core capital), and equity is expensive to

service. Borrowed capital on the contrary is cheap to service. Thus the more, banks gear up (raise loans), the more money they make: gearing equals profits. That being said, a premise for the thesis, which I find rather unproblematic, is that lax regulation serves the banks (at least short-term), and that we can assume that their lobby groups work for such a regulatory practice.

For instance, students of financial industry on EU level (e.g Qugalia 2009) define, based on interviews, the preferences of large (mainly British-based) investment banks as keen to promote market opening, minimal transparency requirements, internal risk management. Similar preferences can be found with the largest lobby organization in Germany, Association of Private Banks in Germany (BdB)[9]. In a survey on the need for reform and structural change of the German Banking Industry, the preferences of the BdB concerns "three strands; namely, an emphasis on self-regulation, less intervention by the state and finally a principles-based, flexible approach to regulation" (cited in Macartney 2009: 467).

There are a broad range of "pathways" to influence one must take into account when studying interest groups: access, selection, voice and structural coercion in order to avoid underestimating interest group power (Dür 2009). Dür (2009: 1221) stresses that opposing groups may have equal access and must be taken into consideration, as they may affect the policy outcomes. This is of limited relevance to this thesis. With very few exceptions[10], the financial and banking lobby at EU level has practically no opposition. Adversaries are rather found within the financial sector i.e. competing banking associations. However, there is reason to believe that although some deviation in preferences, for instance, German and English banking associations have shared interests concerning the liberalization of financial markets, lower capital requirements etc. Due to reasons of space and practicality, in studying interest groups, this thesis will focus mainly on the agenda-setting stage: i.e. the European Commissions consultation with lobby organisations. The Commissions is an "influential supranational actor at the agenda-setting stage, in that it drafts and officially proposes legislation…" (Quaglia 2010: 134). In its own study of lobby environment in the EU, the Commission claims that the earlier in the legislation process, the more effective the lobby effort is (European Commission 2003). Still, where data is available, some attention will be given to the interaction between CESR and CEBS and the financial industry.

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[9] Bundesverband deutscher Banken

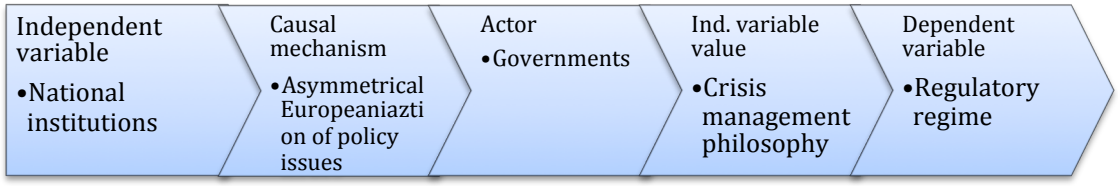
[10] FIN-USE group, selected by the European Commission, monitor and comment on measures affecting the relationship between consumers and small businesses and the financial services providers.

Process-tracing

The thesis combines two methods: process-tracing and "assessing the degree of preference attainment" (Dür 2008). These methods are considered suitable to explore the activity of the financial industry in the policy-making process and subsequently whether financial sector preferences can be identified in financial regulatory policy.

Process-tracing is a very common method to measure interest group influence in the EU (Dür 2008: 562). Defined by George and Bennett, the "method attempts to identify the intervening causal process – the causal chain and causal mechanism – between an independent variable (or variables) and the outcome of the dependent variable" (2005: 206). The approach is helpful when working with a small number of cases to "avoid mistaking a spurious correlation for a causal association" (Mahoney 2003: 363). By applying process-tracing we go "underneath" the mechanism and attempt to give a narrative account of what happened at this stage (in the process). In relation to the thesis, the stage in question is lobby activity. This involves examining the preferences, access and activities of public and private actors, the way decisions undergo change in the political process, the extent in which interest group preferences are present in policy outcomes and interest groups´ statements concerning (dis-) satisfaction with the outcome (Dür 2009: 1223). In order to examine and try to achieve some understanding of interest group influence on financial regulation at the EU level, the thesis attempt to "assess the degree of preference attainment" (Dür 2008). This method involves comparing the preferences of interest group with the policy outcome. If the policy outcome, expressed through directives or regulations, is consistent with the preferences of active lobby groups, it could be interpreted as some level of influence has been exercised. This method is obviously not unproblematic. There are different other factors that could play in, affecting the outcome. Assume that the interest group share the preferences of the policy-makers, and therefor make limited lobby efforts. There is good reason that the policy outcome resembles the preferences of the interest group. To make the interference that lobby influence has been exercised is faulty. One way to overcome this is, were it is possible, to explore closer fragments of the policy-making process. For instance, comparing early legislative drafts (t_0) with following consultation papers by the industry, and in turn final legislative proposals (t_1). Change from t_0 to t_1, if inline with industry positions paper, could reflect influence.

Institutions – Commonly referred to as "the rules of the game", institutional dynamics are at work close to everywhere. This study emphasises how diverse national intuitional structures in Europe affect policy-making at the EU level. The causal interaction, is shown below:



Tranøy's (2000) concept of "asymmetrical degree of stickiness" grasps the same dynamics. Contrasting preferences and institutional structures at the national level, makes some policy issues harder to agree upon, hence more "sticky". For instance, that it seems easier to de-regulate and open financial markets, than to agree on pan European financial regulation. In exploring this causal mechanism I look for signs of political tension between national authorities concerning financial regulation, and/or crisis management issues. This tension has at least two dimensions: (1) intergovernmental (negotiations between governments) and (2) multilevel (negotiations between governments and EU bodies).

It is important to understand these three causal interactions as complementary rather than competing explanations. The purpose of this study is not to measure which one of these causal mechanism best explains the insufficient pre-crisis regulatory regime in the EMU. On the contrary, the thesis understands these three models as valuable to provide clearance to a complex regulatory failure.

3.4 Sources

3.3.1 What is a key document?

One of the hypothesis argue that key EMU documents overestimate the ability of the market to preserve stability and express little concern for financial instability in the planning and development of the EMU. What is a key document? Concerning European macroeconomic polices key documents include (Dyson and Quaglia 2010b: 14):

- Relevant provisions from major agreements and treaties. They include the Maastricht, Amsterdam, Lisbon treaty and the Stability and Growth Pact.

- Relevant EU and ECB legal instruments, including resolutions, directives, regulations and guidelines. This involves the "Lamfalussy directives", and the Capital Requirement Directives.
- EU policy documents, like action programmes, communications, reports, and press releases, drawn from ECB, the Commission, the EP, the council (especially ECOFIN). Examples include, the Delores Report, the Financial Service Action Plan (FSAP), the Bouwer Report(s), the Committee of Wise Men.
- Individual (often non-official) proposals that produce debate, although maybe not adopted in key documents. The "Turner Review" (FSA 2009) is an example of such.

Key banking and financial directives

My second hypothesis argues that strong interests affected rules and regulations that could have made the EMU better prepared for financial crisis. Financial regulation is a sensitive issue. Financial instability and other types of policy failure in this area have high political (and social) costs. The problem area is vast. For reasons of space, the thesis is strategically selective in its engagement. In order to test the hypothesis the focus will be on the Markets in Financial Instruments Directive (MiFID) (2004/39/EC) and the Capital Requirements Directive (CRD) (2006/49/EC). These directives have considerable impact on the supervision and regulation of financial markets and banking. Hence, they can be treated as representative of the regulatory philosophy in the EMU prior to the crisis.

Replacing the Investment Service Directive (ISD), MiFID came into force in 2007 and is arguably the most significant piece of legislation in European financial market integration (MaCartney 2009: 12, Quaglia 2008a, 2009). The *Financial Times* spoke of it as the "new big bang" in financial regulation (Financial Times 2006). MiFID touched upon a broad range of issues in securities regulation concerning pre- and post-trade transparency, client order handling to mention a few. Most important, MiFID retained the EU "passporting" principle and extended the list of financial services and instruments that are covered by passporting. MiFID passport allows firms to operate freely in any member state. Banks and investment firms that are covered by MiFID are authorized and regulated in their "home state". The CRD is considered to be the most important directive issued in the European banking sector the last decade (Christopoulos and Quaglia 2009: 180). It was an effort to make the (non-legally binding) principles of the Basel II Accord into EU law.

3.3.2 Acess and use of sources

The study relies on two main sources: official documents and secondary literature. Gathering official documents is both time consuming and challenging. The EU has good routines in making official documents available online. Through its Europa.eu website a vast amount of working group papers, consultation documents, final directives and treaties dating back to the 80s are made rather accessible. However, the online archives are far from complete, and the most desirable data is not always available. The work of influential committees (e.g. BAC, EFC, EBC, EGCRD) and their respective subcommittees and working groups is not consistently published. The work of some is by default confidential. Since the establishment of the Lamfalussy process, which emphasises transparency, some consultation papers and industry responses are made available. A desirable source of information to overcome opacity issues would have been interviews with committee members, regulators and interest groups representatives. Not having been able to obtain such interviews, the thesis also relies on secondary literature based on interviews with industry representatives and regulatory policy-makers.

Kenneth Dyson and Lucia Quaglia's (2010a, 2010b) collection of key EU documents has been valuable. Repeated visits to the two brick-volumes have been beyond helpful.

4 EMUs Regulatory Regime

The ambition of this chapter is descriptive. The purpose is to shed light on the developments of institutional arrangements for the governing of financial stability, hence the EMUs pre-crisis regulatory regime. The structure of the chapter is thematic and proceeds as follows. Describing the crisis prevention regime the SGP, financial supervision and regulation will be highlighted. Lastly EMUs crisis management arrangements will be outlined. However, prior to this the booming years and the state of Europe on the eve of the financial crisis is described.

4.1 The "booming years" 2000-7 and the state of Europe at impact

The outbreak of financial crises can seldom be pinpointed to a single date. However severe tensions emerged in interbank markets worldwide, including the euro area on August 9 2007 (ECB 2010a: 64). This thesis relies on ECBs dating of the outbreak of financial turmoil, and limits the examination of Europe's regulatory regime to mid 2007. Illustrated by three developments, the purpose of the coming subsections is to show how big, interconnected and fragile the financial and banking system had become under the pre-crisis regulatory regime.

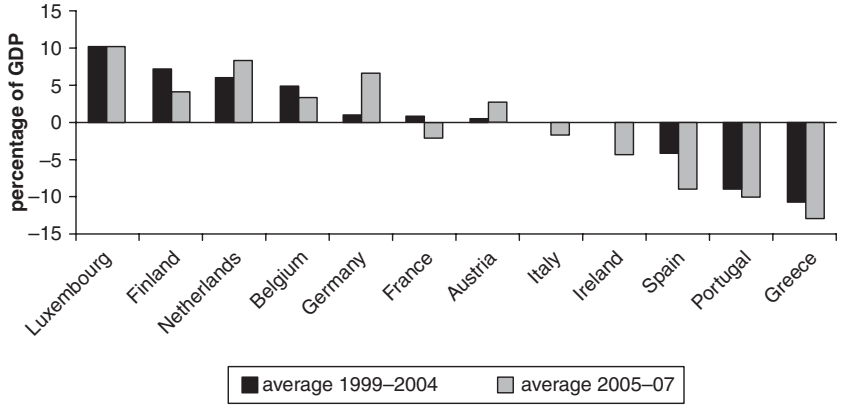
Development #1: Imbalances and interconnectedness

Completing the third and final implementation stage of the EMU, the euro became legally effective from January 1999 under the authority of ECB. At the level of Eurozone as whole, monetary policy was a success story right from the start. Up to 2007, the ECB managed to keep growth and inflation around 2% and, fiscally the 3% target was only violated once by the Eurozone as a whole (Baldwin and Gross 2010: 3). A closer look, though, draws a slightly different picture. The German deficit in the period 2002-5 was respectively -3.7%, -4%, -3.8%, and -3.3% of GDP. Other big nations above the limit were France in the years 2002-4 and Italy from 2003 to 2006 (Underhill 2011: 125). Superior by far, however, was Greece who violated the SGP eight out of eight times (2000-7) (Baldwin and Gross 2010: 5). Worth noticing is that Ireland and Spain, who later suffered debt problems, was of the few to respect the SGP (ibid.).

Between 1999 and 2007 - after the introduction of the euro and prior to the financial crisis – the Eurozone operated with a roughly balanced current account relative to the rest of the world. However, within the Eurozone there where large and sustained imbalances (Favaro et al. 2011). "Core" countries (Netherland, Belgium, Luxembourg) – especially Germany – ran current account surpluses, while "periphery" countries; Greece, Spain,

Portugal and to a lesser extent Ireland struggled with substantial current account deficits (see figure 3 below; borrowed from Favaro et al. 2011:222). Favaro et al. (2011: 222,237) revealed differences in source of economic growth across Eurozone countries (by decomposing the GDP growth rate by component of aggregate demand): Contrary to Germany and Ireland where growth was created through exports, in Greece and Portugal growth was led by a boom in private consumption, while Spain has experienced both private consumption and investment led growth.

Figure 3 Current Account Balance for Eurozone Countries



Source: AMECO database (European Commission).
Note: Countries that joined the Euro Area after 2006 (Cyprus, Malta, the Slovak Republic, and Slovenia) are excluded.

Despite diverging economic growth models, a common denominator for the periphery countries was the source of financing. The adoption of a common currency – reducing exchange risks – and increase in financial activities enabled Greece, Ireland, Portugal and Spain to finance their deficits through cross-border financial and capital movements (ibid: 222-3). Both core-periphery capital flows and differing patterns in exports and wage policies explain the external imbalances within the Eurozone. The huge inflows of capital caused a boom in the periphery raising costs and prices compared with the core (Krugman 2011). While Germany´s growth strategy was export led, Greece, Spain and Portugal strategies focused on expansion of domestic demand (Favaro et al. 2011:226). As the core and periphery pursued diverging wage and labor policies and growth strategies, the gap in competiveness widened.

The distinct variation in performance among EMU countries produced massive current account imbalances. One countries debt became another's loan, and banking and financing became highly interconnected across the Eurozone. The balance sheet of core

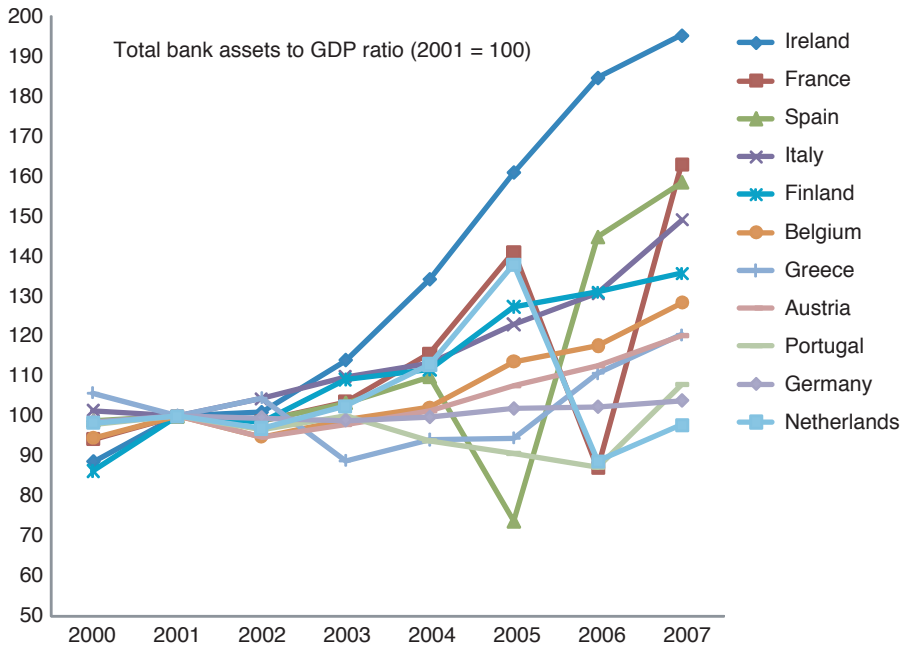
banks (mainly Germany) where filled with PIGS debt (Table 3, borrowed from Baldwin and Gros 2010: 11).

Table 3 Intra-Eurozone banking exposure, EZ core banks' holding of PIGS debt

	1999 4th quarter	2009 4th quarter	Percentage change 1999–2009
Portugal	26	110	320
Ireland	60	348	481
Italy	259	822	217
Greece	24	141	491
Spain	94	613	554
GIPS	204	1212	495
Total	463	2033	340

Note: EZ core is Germany, France, Austria, Belgium and Netherlands
Source: BIS Consolidated Banking Statistics, June 2010

Figure 4 Growth in bank-asset-to-GDP, 2000-7



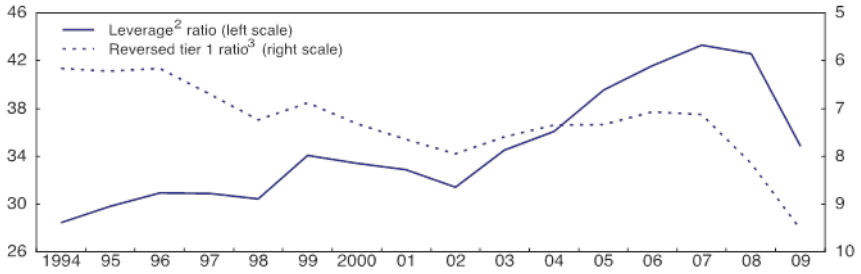
Source: European Banking Federation and Eurostat.

National regulatory practices also proved less prudent, as illustrated in figure 4 above (borrowed from Baldwin and Gross 2010: 6). European banks aggressively expanded lending. An extreme case, for sure, Irelands total bank asset as percentage of GDP increased from 360% in 2001 to 700% in 2007. In the same period numbers for other big lenders were: France from 230% to 373%, Italy from 148% to 220% and Spain from 177% to 280%.

Development #2: Leveraging: too-big-to-fail or too-big-to-save?

In the pre-crisis period, loan growth and risk-taking was facilitated by increase in leveraging by banks. From 2002 to 2006 assets grew faster than capital. Although the increase in aggregate leverage of Eurozone banking system was modest, it was substantial for the largest and most systemically relevant banks (Barnes et al. 2010: 7). Figure 5 (borrowed from Barnes et al. 2010) below show the leverage ratio of the ten largest banks in the Eurozone amounted to a gearing over forty-three, around mid 2007. This is equivalent to holding 2.3% (accessible) capital to assets. This was far below the minimum capital requirements set out in the Basel II Accord, and indicates that these banks where in a fragile state in case of large losses.

Figure 5 Leverage of largest EU banks[1]



1. The 10 largest banks in the euro-area are selected based on their total assets in 2006, which is the last pre-crisis year, and include BNP Paribas, Crédit Agricole, Deutsche Bank, ABN AMRO, Société Générale, ING Bank, Banco Santander, UniCredit, Fortis and Commerzbank.
2. Ratio of total assets to tier 1 capital.
3. Ratio of risk-weighted assets to tier 1 capital.

If we go into detail, the leverage ratio of individual institutions reflects risky and aggressive growth strategies. Below, the list is expanded to the twenty largest banks, including non-Eurozone banks as well (UK and Switzerland) (Table 4). The list shows a severe gap between leverage ratio and official regulatory ratios. In line with the Basel II, the CRD imposed a minimum capital requirement of 8% (capital to asset), which inversed sets a gearing ratio (assets to capital) roof at roughly twelve. In late 2007, investment bank and European giant, Deutche Bank had a capital asset ratio of 1.4 percent, which is equivalent to a gearing over seventy! In a letter to the *Financial Times*, Daniel Gros and Stefano Micossi expressed concern over the German banks' leverage ratio. Allegedly, the total liabilities of Deutche Bank amounted to about €2000bn or more than 80% of Germanys GDP (Gros and Micossi September 2008a). This was clearly a too heavy burden for the Bundesbank (or German state), which like other EMU-members are bound to the budgetary rules of the SGP.

Table 4 Leverage ratio in Europe´s twenty largest banks, end 2007

Bank	Country	Leverage ratio
Deutche Bank	Germany	1.40
UBS	Switzerland	1.44
Société Générale	France	2.02
BNP Paribas	France	2.22
Barclays Bank	UK	2.23
RBS (Royal Bank of Scotland)	UK	2.33
Credit Suisse	Switzerland	2.55
ING Bank	Netherlands	2.99
Crédit Agricole	France	3.03
UniCredit	Italy	3.18
Fortis Bank	Belgium	3.35
HBOS (Halifax Bank of Scotland)	UK	3.66
Lloyd TSB	UK	3.95
BBVA	Spain	4.11
Intesa San Paolo	Italy	4.24
Santander Central Hispano	Spain	4.35
Crédit Mutel	France	4.41
HSBC Holdings	UK	4.46
Rabobank Group	Netherlands	4.99
Groupe Caisse dÉpargne	France	5.03

Source: Lybeck 2011: 243 Note: the banks are arranged after leverage ratio, not size.

Barclays (leverage ratio of 60!) total liabilities where close to £1,300bn or roughly equivalent to the GDP of the UK. An extreme case is the Belgium bank Fortis Bank. Having completed the acquisition of Dutch bank ABN AMRO in late 2007 (Allen et al. 2010: 26), Fortis Bank had surpassed its domestic economy. Although the leverage ratio amounted to "only" 33 compared to other banks (table 4), Fortis Bank had liabilities that were three times the GDP of its home country (Gros and Micossi 2008a). According to Gros and Micossi (2008a) some of the largest banks had become so overleveraged, that they were "not only to big to fail, but also too big to be saved".

Development #3: Rise of cross-border banking

According to an IMF report, the business of the majority of Europe's 8,000 banks is of national character (IMF 2007: 5). Still, as of June 2007 large cross-border banks had emerged and made up a substantial share of the market (ibid). A mapping exercise of EU banking groups with significant cross-border activity (Trichet 2007) based on 2005 data,

reveal that 46 larger, complex financial institutions (LCFI) hold over 68% of EUs overall banking assets. Out of these, 16 "key-cross-border-players" hold an average 38% of their EU assets abroad (ibid). Reviewing data from 2008 the image is even clearer. Below (Table 5), twenty European "systemic important financial institutions" (SIFI) has been identified holding on average 65% in foreign assets. A closer look shows that some of the largest banks hold over 80% in foreign assets.

Table 5 Cross-border activity of Systemic Important Financial Institutions

Banks	Total assets (bn of $)	% of foreign assets
Royal Bank of Scotland	3511	46 %
Deutsche Bank	3066	82 %
Barclays	3001	68 %
BNP Paribas	2889	41 %
HSBC	2527	64 %
UBS	1888	89 %
ING	1854	60 %
Societe Generale	1573	29 %
Santander	1461	64 %
UniCredit	1455	62 %
Allianz	1310	88 %
Credit Suisse	1097	85 %
Axa	921	75 %
Banca Intesa	885	15 %
BBVA	755	30 %
Aviva	507	64 %
Standard Chartered	435	71 %
Aegon	393	78 %
Zurich	309	96 %
Swiss Re	214	97 %
Average Europe	1503	65 %

Source: Claessens et al. 2010: 15 Note: data refer to 2008

The increased financial integration has led to larger and more multi-country banks, witnessing an increase in cross-border mergers and acquisitions within (Western) Europe. Most notably the takeover of Erste Bank in Austria and Hypobank in Germany by Italian bank Unicredito and, the takeover of the UK Abbey National by Spanish Santander. A big acquisition close to the crisis was that of Dutch ABN AMRO by Belgian Bank Fortis (Allen et al 2011: 26). Mergers accompanied with banks taking more and more risk, many banks achieved too-big-to-fail status. Some even grew beyond the size of their home

economies turning them into “too-big-to-save” banks (Demirguc-Kunt and Huizinga (2010) cited in Allen et al. 2011: 28).

4.2 Crisis Prevention

The previous section painted a picture of a deeply financial integrated Europe with a growing interconnected banking system. The main purpose of the coming subsections is to describe the EMUs crisis prevention regime that allowed for these developments. Here, crisis prevention is understood as regulation and supervision. Although these two are highly connected, they will be presented separately for structural reasons. Although, belonging to fiscal policy and not regulation per se, the Stability and Growth Pact is included as it was seen as paramount to preserve stability in the Eurozone.

4.2.1 The Legacy of Maastricht

As early as in the 1960s, the Commission began working on coordination of banking regulations between member states (Pauly 2008: 5). However the great transformations of financial integration in Europe took place in the late 1980s, early 1990s. The establishment of the single market and The Maastricht Treaty, EMUs founding document, stands out. In the ink of Jaques Delors the 1985 White Paper on the single market urged to take actions to improve the efficiency of resource allocation. This was to be obtained through market liberalization: guaranteeing free movement of goods, capital services and people. The White Paper also set a December 31 1992 deadline for the competition of the single European Market. This timeframe reflects the intensive years in the run up to the Maastricht Treaty (and maybe why many issues were left unresolved in Maastricht).

In June 1988, the Directive 88/361/EC on full liberalization of capital movements was completed. Short after, the Delors Committee was set up to provide a plan for the implementation of the EMU. Key documents at the time, such as the Pado-Schioppa Report and the Commissions “One Market, One Money” report, advocated that a single currency would provide and increase economic gains from an internal market by eliminating exchange-risk and reducing transaction costs (Pado-Schioppa et al. 1987, Emerson et al. 1990). As will be discussed in chapter 5, these reports would prove influential on the Delor Committees final proposals on EMU, and consequently on the statue of the Maastricht Treaty.

The Maastricht Treaty provided a road map for a single currency and an independent central bank to regulate it (Hallerberg and Bridwell 2008: 71). The road map consisted of a

set of economic convergence criteria, also known as the "Copenhagen Criteria's". For admission to the single currency union, the primary criteria are as follows:

Inflation rates. Consumer price inflation rate must be no more than 1.5 percentage points above the average of those three member states with the lowest inflation rates.

Government finances. This essential criterion's, known as the Excessive Deficit Procedure, is two-folded:

- Annual government deficit. Neither "planned or actual government deficit to gross domestic product" shall exceed 3 percentage of GDP.
- Government debt should not exceed 60 percentage of GDP.

Exchange rates. At least two years prior to the examination for admission, the country should have observed "normal" fluctuations margins of the ERM and not devalued against the currency of another ERM member.

Long-term interest rates. In the year prior to examination, the long-term interest rate must be no more than 2 percentage points higher than the average of those of the three member states with lowest inflation.

The purpose of these criteria's was to encourage economic discipline and prepare states for a single currency. However, in core Europe there seemed to be distrust that member states would act fiscally disciplinary as the euro came into effect and thus called for sanctions procedures. This led to an agreement on formal rules on budget deficits and sovereign debts: the Stability and Growth Pact. In fact, the SGP resembles the only collective mechanisms for dealing with crises in the EMU. The Pact will be described next.

4.2.2 The Stability and Growth Pact

The Maastricht Treaty was an "incomplete contract" as far as formal rules are concerned, and "voluntary arrangements had been the implicit road" chosen in the Treaty (Heipertz and Verdun 2004: 768). Echoing recommendations from the Delors Report, the German (and Dutch) position preferred a more rule-based system that would restrict budget deficits as the EMU reached its operational and final stage. Faced with increasing discomfort among public opinion with the EMU, a German proposal for a "Stability Pact" was put forward in November 1995 (Waigel 1995, Federal Finance Ministry 1995). The German position and the work of the Monetary Committee (CEC 1996a, 1996b, 1996c) were

decisive in the shape of the Pact (Heipertz and Verdun 2004). At the Amsterdam European Council in June 1997, the Stability and Growth Pact (SGP) was agreed upon.

The heavily debated piece of legislation was meant to supplement the Maastricht Criteria's and specifically clarify the excessive deficit procedure (EDP). The SGP would guarantee the "economic homogeneity" of EMU-members before the introduction of a single currency and foster internal-stability in the Eurozone afterwards (Exenberger 2004: 1). The SGP specifies type and scale of sanctions to be applied on member states with persistent excessive deficits and recognizes that the 3 % deficit celling is to be respected even under "unfavorable economic circumstances" (Buti & Sapir 1998: 15). The need for a strengthened EDP was build upon a concern that excessive deficits would undermine the independence of central banks. It was accompanied by the worries that the no-bail out clause would be "endangered by unsustainable fiscal paths of certain member states" (Heipertz and Verdun 2004: 767). The SGP has both preventive and corrective mechanisms (Hallerberg and Bridwell 2008: 72). The preventive focuses on detailed monitoring of what members states are doing. States have to write either stability (euro members) or convergences programs (non-euro members) to be submitted to Commission for review. The corrective dimension involves the Commissions assessment of a given state's domestic policy. If both excessive deficits existed and no action deemed to eliminate it, the commission can penalize the state.

4.2.3 The supervisory system

Regulation is only half the job. Without prudential supervision, adequate regulatory policies are likely to be ineffective, and crisis prevention is challenged. Supervisory arrangements in the Eurozone are based on the principle decentralization. This involves transferring supervisory authority to the lowest level of government that can perform the task efficiently. This principle was made explicit in Art 105 in the Maastricht Treaty (TEU 1992). This has produced a "disjunction" (Quaglia 2010) between two realities: (1) financial regulation is largely designed at EU level, and (2) financial supervision, understood as monitoring and compliance of rules is left to national authorities. The fragmentation of responsibility and authority, constrains national officials ability to perform prudent regulation and supervision of markets and institutions in their domain. This was further complicated by the Investment Services Directive (93/22/EEC) (ISD) issued soon after Maastricht. The ISD created a "European passport", which provided for a cross-border right for investment firms to operate freely across the EU (Jackson 2009: 32).

The ISD was based on the principle of home country supervision. Tension arises as the home country is held responsible for the supervision of a financial institution and the host country responsible for financial stability. This implies that the mandate of home country supervisors' do not involve any co-responsibility for financial stability in partner countries, but host country supervisors mandate include financial stability, but no authority to supervise foreign financial entities, (unless they operate through subsidiaries) (Pisani-Ferry and Sapir 2009: 5). Moving away from the concept of minimum harmonization, laid out in Maastricht, MiFID introduced "maximum harmonization". The concept provides for a maximum level of a regulation that sets the maximum allowable standard that can be adopted in domestic law or regulation (Jackson 2009: 33-4). Despite ongoing debate and concern for limited responsibility and authority of host country supervision, MiFID put more emphasis on home country supervision, through the maximum harmonization principle. As emphasized earlier, without formal and clear-cut arrangements for information sharing and cooperation, the strong home country principle constrains the host country supervisors' ability to oversee and preserve financial stability.

Lessons from the Icelandic banking crisis illustrate this (FSA 2009: 38). A key element of the Directive is that it grants European banks that are considered by their home country supervisors as sound, the right to operate branches in other member states. This right is often referred to as "passporting". Through the European Economic Agreement (EEA), Landsbanki, one of Iceland's biggest banks, took advantage of this right by establishing Internet banks in countries like the UK under the Icesave brand. However, there was no corresponding demand to build up national deposit insurance. As "a result depositors in one country (or the government) can be vulnerable to the failure of banks in another country if the home country concerned lacks the supervisory resources to ensure bank solvency, or the fiscal resources to fund bank rescue, and if the deposit insurance cover is low and unfunded" (ibid.). The Financial Service Authority (FSA), as the country host supervisor, had limited powers concerning the supervision of local liquidity. When Landsbanki collapsed in October 2008 it had about £4.5 billion of retail deposits outstanding. The Icelandic government indicated that they were not in a position to meet these liabilities (ibid.). This shows some of the weaknesses with "passporting" activity and the disjunction between regulators (EU level) and supervisors (national level).

The strongest argument against supervisory reform was that banking was mostly domestic, and consequently there was "an informational advantage in keeping supervision at the

national level" (Pisani-Ferry and Sapir 2009: 5). Being true at the time, this was a fair argument. However, the validity of the argument shrunk as cross-border banking in Europe rose.

The launch of the Euro functioned as a "catalyst" for financial integration. As the banking and financial markets got more integrated, described above (4.1), the Eurozone was faced with "the trilemma in financial supervision": the inherent compatibility of integration, financial stability and national financial supervision (Schoenmaker 2005). In a similar fashion as Mundell's famous trilemma, Schoenmaker argue that only two out of the three objectives are mutually consistent (2005: 398-9). In an EMU context, this would suggest that, with an integrated financial market and national financial supervision, financial instability was inevitable. The lack of a pan-European supervisory body triggered debate, as only monetary competence was transferred to the ECB when the euro was introduced. The fact that the ECB is given no role in prudential oversight raises concern for who is to be responsible for macro-stability (Lannoo 2005: 486-7). A situation where ECB has no role in financial stability oversight can undermine the monetary objective of the ECB (price stability) as national central banks could provide liquidity assistance to troubled banks. Uncoordinated liquidity assistance can lead to market distortions, as national central banks could be faced with political pressure to save insolvent – as opposed to illiquid – banks (Lannoo and Casey 2005: 1). Informal efforts were made to overcome this. ECBs Banking Supervision Committee was set to inform the Eurosystem as soon as major problems in the banking system arose (ECB 2000: 98). Simultaneously, a new regulatory framework with serious consequences for the division of power was in the making.

4.2.4 Financial regulation

In the late 1990s, limitations with existing regulations, most notably the Investment Service Directive (ISD) and the Capital Adequacy Directive (CAD), were identified.

At the turn of the millennium, in the footsteps of the newly launched euro, financial integration in Europe intensified. Regulation and supervision of financial services in the EU underwent major reforms (Posner and Veron 2010). In May 1999, the European Commission issued the Financial Service Action Plan (FSAP). Replacing the ISD, the Plan consisting of some forty odd directives, aimed at removing the remaining formal barriers in the financial market between EU members and establish a legal and regulatory environment

that supported financial integration of EU markets[11]. The plan was to be completed by 2005. It must be seen as a success as 39 of 42 directives was adopted in time.

Like previous legislation, the FSAP supports an approach that combines EU directives and national laws. In short, the EU directives provide for a general level of regulation "concerning the provision of financial services across borders and the harmonization of national regulations governing cross-border activities" (Jackson 2009: 33). The directives are intended to meet three specific objectives: (1) a single wholesale market (securities); (2) an open and secure retail market (insurance), and (3) a state-of-the art rules and supervision (ibid). An infrastructure for further integration and the implementation of these directives was needed: the answer became the infamous "Lamfalussy Process".

A "new" degree of consensus over opening and integrating financial markets has characterized the single financial market in the new millennium (Macartney and Moran 2008: 327). According to some (Quaglia 2010, Macarntey and Moran 2008), the establishment of the Lamfalussy Process is the single most important (recent) development in EU financial markets. The Process provides a framework for updating the EUs financial regulations and developing supervisory practices. On demand from the Lisbon Council 2000, an ad hoc working group the Committee of Wise men, chaired by EU-integration veteran Baron Alexandre Lamfalussy, was assembled to examine the state of the EU financial market. The report was based on a committee consensus that the current regulatory framework was "too slow, too rigid, complex and ill-adapted to the pace of global financial market change" (Lamfalussy 2001: 7). The process (reproduced below; Figure 6) contains of "four" levels focusing on different stages of the implementation of the process. Worth noticing is that the structure indicates that only framework directives needs to be approved by Parliament and Council, before technical details are negotiated at Level 2 by a Committee in consultation with the industry (Macartney and Moran 2008: 328). Originally limited to securities market regulation, the Wise Men (sic) advised it to be extended to banking and insurance sector (ibid). A range of legislative measures to regulate financial services has been adopted since the early 2000s.[12] Dominant pieces of legislation,

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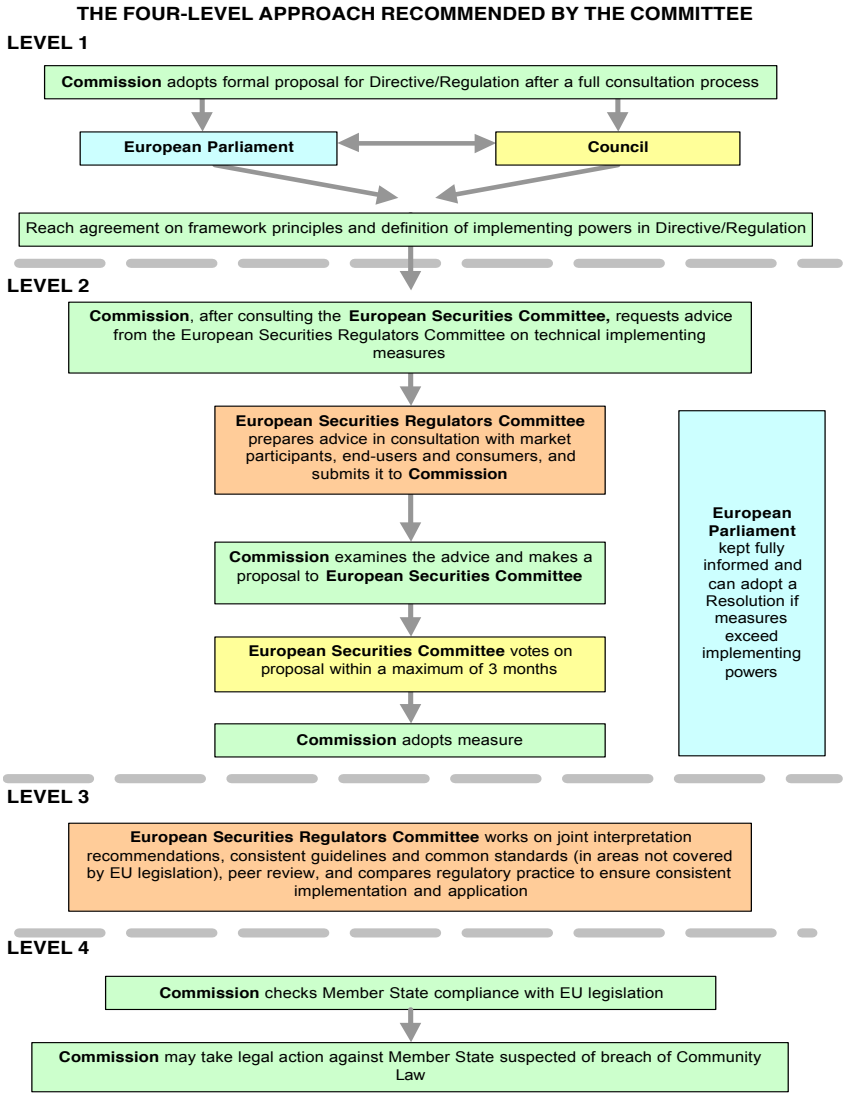
[11] *The EU Financial Services Action Plan: A Guide,* HM Treasury, the Financial Service Authority, and the bank of England, 31 July 2003.

[12] Other key directives include the Financial Conglomerates Directive (2002), the "Lamfalussy Directives": the Market Abuse Directive (2002), the Prospectus Directive (2003), the Transparency Directive (2004).

notably the Markets in Financial Instruments Directive (MiFID) and the Capital Requirements Directive (CRD) had great impact on the crisis prevention regime.

Figure 6 The Lamfalussy Process



Source: Lamfalussy 2001: 6.

As the negotiations on the Basel II agreement began, member stated in the EU agreed that the new framework for capital requirements agreed in in the new Basel Accord was to be incorporated into EU law. This resulted in the Directive 2006/48/EC (pursuit of the business of credit institutions) and Directive 2006/49/EC (capital adequacy). The CRD shared the rationale of Basel II and was articulated on three pillars: minimum capital requirements, supervisory review of capital adequacy, and market discipline. Despite

common foundation, the application of the CRD was wider. Three differences can be identified (Quaglia 2010:56-7). Basel II is an international agreement, whereas the CRD only imply to twenty-seven EU member states. Second, as appose to the legally-binding CRD, Base II was a non-legally binding "gentlemen's agreement". Lastly, Basel II was confined to internationally credit institutions (banks), whereas CRD included investments firms: international and domestic in nature.

In retrospect, in light of the crisis, this micro prudential regulatory philosophy has revealed shortcomings. The following account is by no means complete, but is meant to illustrate key aspects of CRD and inherent limitations. The regulatory approach in the EMU emphasizes internal capital assessment by financial institutions. The main point is that banks develop better internal controls and risk management. Through mathematical models financial institutions are trusted to individually calculate exposure to credit, market and operational risk, and consequently evaluate its capital adequacy. This arrangement may be pro-cyclical, and foster herd behavior. Since pro-cyclicality is a key source of systemic risk (and the emergence asset bubbles) (Claessens and Underhill 2010: 124), CRD could fail to enhance the safety and soundness of the system as a whole. Like Basel II, CRD relies greatly on market signals (prices and ratings). This makes its unclear whether "best" risk management practices in individual institutions foster stability at system level. Considering multiple banks that apply similar (risk) models respond simultaneously and in similar ways to (perceived) risks and opportunities – based on price signals and ratings in the market – "downturns and upturns may be reinforced as banks downgrade or upgrade clients and adjust prices on a large scale" (ibid: 125).

These risk assessment approaches advocated by the CRD focus on credit, market and operational risk: Where specific attention is given to the use of value-at-risk measures.[13] The regulatory approach puts little emphasis to liquidity risk. This is unfortunate considering that as the system turn from "good" to "bad weather" the main systemic risk for an individual bank is illiquidity, with funding drying up and prices of securities and assets plunging due to fire sales (Carmassi and Micossi 2012: 44).

In line with Basel II recommendations, the principle of supervisory review of capital adequacy was made EU law through CRD. Banks were encouraged to develop sounder risk management routines calculate and manage their risk exposure. The Supervisory review process stated that regulators and supervisors would monitor the banks risk management

[13] Directive 2006/48/EC Annex V

practices and intervene if capital ratios were to go below minimum capital requirements. The process was based on dialogue between financial institutions and supervisors and the guidelines for intervention were mainly voluntary. Financial regulation in Europe also emphasized market discipline. Disclosure of banks own information would promote transparency and enhance market discipline by allowing customers insight o the bank's risk profile. Market discipline would prove that "supervisory oversight is essentially redundant" (Claessens and Underhill 2010: 120). Market participants are then able to identify and punish a faltering institution, the less the need for supervisory intervention. The recent financial crisis indicates that market discipline through enhanced disclosure not necessarily provide the best guarantor of sound risk management.

Crisis prevention, through prudent regulation and supervision of the financial system, should be the first preoccupation of national and EU authorities. However, if worse comes to worse, and history tells us that it often will eventually, crisis management routines should be well established.

4.3 Crisis management arrangements: shortcomings and inconsistency

For the reoccurrence of financial crisis, history provides us with evidence aplenty (Kindleberger and Aliber 2011, Reinhart and Rogoff 2009). So there is good reason to be prepared. In this respect EMU states seems surprisingly unprepared for any wider systemic financial instability. As it did before the EMU, the main responsibility for financial stability and formal authority for crisis management lies at the national level. More specifically, it lies with the national supervisory authorities, central banks and treasuries.

Emergency liquidity assistance

As elaborated earlier (2.2.4-5), the role of a LOLR is important to perform effective and quick crisis management. In this manner, the Eurozone seem ill equipped to cope with financial instability. The responsibility for the management of financial crisis is everything but clear in the formal rules of the Eurozone. In the early years of the Eurozone there was debate concerning a LOLR for Europe (Goodhart 2000). In particular if the ECB should perform this function. Some critics came from "within", so to speak. In the words of,

Alexandre Lamfalussy[14], "the present institutional set-up in Europe regarding crisis prevention (and potentially also crisis management) looks to me, to put it mildly, sub-optimal…" (Lamfalussy 2004: 4).

The statute of the ECB and the ESCB, as laid out in the Maastricht Treaty, grants no specific powers to the ECB to cope with financial disruptions that might occur (Article 105-108). Although, there is one exception: Article 105 (2) does declare that the ECB is "to promote the smooth operation of payment systems". But besides this, any other contingency, such as a credit squeeze in the European banking sector as witnessed in 2008/9, the Maastricht Treaty is silent. Nothing is said about any formal authority for the ECB to act as a LOLR. A silence that, according to Garry Shinasi, makes the ECB the "ultimate "narrow central bank" (2003: 3 cited in Cohen (2008: 41)). Financial stability is left out, as the ECB mandate only focus on price stability. As decentralization – the notion that the lowest level of government that can efficiently carry out a function should do so – persists as "the ruling principle of the Eurozone" (Cohen 2008: 41), effective emergency liquidity assistance (ELA) to cross-border institutions is challenged (Pisani-Ferry and Sapir 2009: 6). As mentioned above, the responsibility of ELA to Eurozone banks is placed with the national central banks. In the case of a cross-border bank, the responsibility to provide liquidity assistance resides with the central bank of the host country. Now, as banking supervision is also national – with the responsibility for the cross-border bank assigned to the home country – there is a risk of insufficient flow of information and limited cooperation between home and host country authorities in the case of financial distress. In addition the ECB has no formal supervisory authority "nor privileged access to information from national supervisors" (ibid). Worth noticing is that during the early stages of the financial crisis the ECB proved quite vigorous. As severe tensions in the interbank market emerged in August 2007, the response from the ECB was rapid and the liquidity crisis in general in the Eurozone was handled (Pisani-Ferry and Sapir 2009: 9). Nonetheless, in order to take necessary action to overcome collective action problems across the EU banking and financial system, the ECB had to exceed its (price stability) mandate (Underhill 2011: 123).

[14] Baron Alexandre Lamfalussy is an EU-integration veteran most notably as the first President of the EMI (ECB predecessor) and chairman of the Committee of Wise Men (see 4.X).

There are reasons not to blindfolded trust these decentralized arrangements to ensure the smooth functioning of the system as a whole. Consider that a large, complex financial institution with extensive cross-border activity encounters financial troubles. Will national authorities share an equal view (and intervene accordingly) of this troubled pan-European bank as matter of common interest? Prior to the crisis there was no way of knowing. But as Benjamin Cohen contemplates; "it is difficult to imagine the national supervisors pursuing European interest first and national interest second" (2008: 42).

During financial distress, cooperation is key to overcome contagion effects and prevent the crisis to intensify. Within the Eurozone (as well as the EU), cooperation during a crisis situation concerns the exchange of information. Following the recommendations of the Brouwer Report (EFC 2001), a Memorandum of Understanding (MoU) on high-level principles of cooperation between banking supervisors and central banks of the EU in crisis management situations was adopted in March 2003. The MoU was not made public, but according to a press release, "it consists of a set of principles and procedures for cross-border co-operation between banking supervisors and central banks in crisis situations. These principles and procedures deal specifically with the identification of the authorities responsible for crisis management, the required flows of information between all the involved authorities and the practical conditions for sharing information at the cross-border level. The MoU also provides for the setting-up of a logistical infrastructure to support the enhanced cross-border co-operation between authorities" (ECB 2003).

Burden-Sharing

So far, this subsection has dealt mainly with liquidity issues of crisis situations. Central banks as LOLR only provide assistance to illiquid institutions. As a bank becomes insolvent, the responsibility of crisis management shifts from the central bank to treasury. In the case of EMU (or EU for that matter) there is no such thing as a common treasury. Nor is there a common European pool of resources in the event of solvency issues. This (lack of) institutional arrangements, transfers the responsibility of crisis management to the national treasuries. The cooperation amongst treasuries (and their respective central banks) is evident at the level of ministers and central bank governors through the ECOFIN Council (Pisani-Ferry and Sapir 2009: 7).

Explicit crisis management arrangement at EMU level prior to the crisis was limited. The only ex ante arrangement that existed was a MoU on co-operation between the Banking

Supervisors, Central Banks and Finance Ministries of the European Union in Financial Crisis situations (ibid). Like the previous, the content of the MoU was confidential. According to a press release, it included arrangements for the development of contingency plans for the management of crisis situations, along with simulation exercises and stress tests (ECB 2005). The MoU was explicitly non-legally binding. Also, it made no comments on burden sharing agreements among national treasuries in the case of financial turmoil.

Following the MoU, there were discussions on burden sharing in the event of cross-border bank failures (Goodhart and Schoenmaker 2006), but without results (CEPS 2008: 28). The lack of burden-sharing procedures beforehand might weaken the ability to coordinate crisis management, as was the case with the Fortis Bank. In late September 2008, merely two weeks after the collapse of Lehman Brothers, the Belgian-Dutch owned bank Fortis went bankrupt. The Benelux coordinated rescue of Fortis, was all but smooth. It generated heated debate on the issue of burden sharing and created political tension between Belgian and Netherlands officials (Gros and Miscossi 2008b). A general crisis fund beforehand could have contributed to the pooling of risk, and more rapid and coherent responses to solvency issues. Being soft law, and not enforceable, the reliance on MoUs for ex ante burden sharing mechanisms does not seem sufficient. Relying on "improvised co-operation" (Freixas 2003) may result in expensive and lightly ex post negotiations on burden sharing between home and host countries in case of cross-border issues.

5 Empirical analysis

The previous chapter demonstrated that institutionally, the EMU seemed ill prepared for a financial crisis; suffering from inadequate regulation for systemic objectives, loose coordination of supervision and limited ex ante crisis management arrangements. Put differently, the last two decades two uneven developments have taken place in Europe. (1) Liberalization of capital (through the single market program) and a single currency has created an interconnected financial market. (2) Simultaneously, although subject to change, regulatory regime of the EMU has lagged behind. A gap between financial integration and financial regulation has emerged; making the EMU regime inadequately prepared to prevent and cope with financial distress. The purpose of the following sections is to analyze possible explanation to this gap. The analysis is guided by theoretical models and hypothesis set out in chapter 2.

First a brief note on how the document review is structured. Policy documents and reports constitute the main sources of this study. Policy documents or report often address consequences of the policy in question e.g. financial directive. Thus positive and negative effects with the directive are put forth. A division between positive and negative argumentation guide the document review. When the documents are reviewed, emphasis is put on what is being said, what they are concerned of achieving (positive arguments). In addition the review include what they do not say, or what they say is not important or necessary (negative argument).

5.1 Regulatory philosophy: the pivotal role of ideas and expert committees

> "*The probability of a large scale cross-border financial crisis in the EU is low*" (EFC September 2007: paragraph 3).

As cited earlier, in relation to the governing of financial stability; regulatory philosophy can be understood as states actors' belief about the proper scope, goals and methods of government intervention in the economy an the nature of the market. The following subsection intend to analyze the role of (economic) expert committees on affecting the regulatory philosophy of the EMU regulatory regime, and hence their (intellectual) preparedness. With caution, the following subsections argue that there is substantial coherence between the regulatory philosophy of the pre-crisis regulatory regime of the EMU and the ideas of a certain economic tradition: neoclassical economics.

Hypothesis I: In economic policy documents concerning EMU there is a systemic overestimation of the markets ability to preserve stability and a systemic underestimation of financial instability and the accumulation of private debt.

5.1.1 The policy agenda: not debating financial stability

The purpose of this subsection is to illustrate that ideas concerning financial instability was led felt out of policy discussion. The latter part of my idea-oriented hypothesis (HI) proposes "systemic underestimation of financial instability" in EMU policy documents. Documenting non-decisions and lack of concern for an issue (financial instability) is not an easy task. The fact that financial (in)stability, literarily, was left out of the agenda (policy documents and public debate) prior to Maastricht and throughout the 1990s may represent a finding in it self. The subject emerged in explicit terms after the launch of the euro, represented by two (rather brief) committee reports (EFC 2000, 2001). Although, given the nature and importance of the subject, the debate that followed is best characterized as limited.

Straight forward the rationale for a monetary union and a single European market is the elimination of exchange-rate risks and increase in economic gains through trade. According to the infamous and well-cited "Cecchini report" published in 1988, the economic benefits deriving from a single, more competitive financial market "could rise to 200 billion ECU[15] or more" (Cecchini et al. 1998: 2). The report gave no thoughts on systemic (stability) consequences coming from extensive liberalization and integration of financial markets. In the run up to Maastricht a series reports was published contemplating economic aspects with an economic and monetary union for Europe. A key contribution was the Padoa-Schioppa Report, that according to Dyson and Quaglia (2010a: 340) was one of "the intellectual foundations of the Commission's proposals on the EMU". The report, named after the Italian banker and economist and who chaired it, was presented by a study group of economists and central bankers appointed by the Commission. A key message of the report was the notion of the "inconsistent quartet"[16]: which states that free trade, full capital mobility, fixed exchange rates, and monetary policy autonomy cannot coexist without one collapsing.

[15] Used as the unit of account until replaced by the Euro.

[16] This is similar to "the impossible trinity".

> "As regards *monetary stability*… In a quite fundamental way, capital mobility and exchange rate fixity together leave no room for independent monetary policy" (Pado-Schioppa et al. 1987: 5, their emphasis).

In a single sentence, the report briefly makes note of the risk of instability in financial markets:

> *The economic importance of the financial services sector is even greater when account is taken of the size of capital flows that it mediates, the risk of instability that is inherent in financial markets, and the links between finance and all other fields of economic activity"* (Pado-Schioppa et al. 1987: 38).

However, it appears mere as lip service as it proceeds emphasizing "home country control" (ibid) and the principle of subsidiarity (ibid: 38), failing to address macro-economic issues.

At the European Council's meeting in Madrid June 1989 a Committee, chaired by Commission president Jacque Delors, was entrusted studying and proposing concrete stages towards an economic and monetary union. The "Delors Report", considered a very influential paper in structuring discussions and negotiations, and is highly consistent with the Maastricht Treaty (Verdum 1999, Dyson and Quaglia 2010a), echoed many of the propositions from the Padoa-Schioppa Report. The overall message was the need for "greater convergence of economic performance" and an independent European central bank with a Treaty mandate to deliver price stability.

When addressing *problems and perspectives* (Delors 1989: 10-13), a part of the report one should expect to find warnings or concern, little attention is devoted to dangerous concerning full liberalization of capital markets and a single currency. The report briefly notes that;

> "*With full freedom of capital movement and integrated financial markets, incompatible national policies would quickly translate into exchange rate tensions and put an increasing burden on monetary policy*" (Delors 1989: 15.

Although the prudence of economic agents are considered important by the report, The Delors Committee stresses that the functioning of a economic and monetary union depend on mutually consistent and sound behavior of governments.

> *"In particular, uncoordinated and divergent national budgetary policies undermine the monetary stability and generate imbalances in the real and financial sectors of the community"* (Delors 1989: 23).

The point to be made here is the implicit assumption that it is the behavior of governments, not markets, that threatens stability. If governments act with budgetary discipline, stability will prevail. As we shall see later (5.1.3), this rationale was key in the making of the SGP.

Throughout the report, a strong emphasis was put on market-oriented economic principles. Although, diverse national policies give rise to public intervention in the provision of certain social services and public goods, the economy should be based on a large degree of freedom for market behavior and private economic initiative (ibid: 16-17). The Commissions final proposal and the final statue of the Maastricht corresponded closely with the Delors reports recommendations (Verdun 1999). The Treaty was based on the principle of decentralization, or subsidiarity, mutual recognition (free flow of goods and services) and home country control. Safeguarding financial stability under such institutional arrangements is challenged by the tension between impetus towards financial integration on one hand and the decentralized approach on the other, in particular concerning supervision. Opening financial markets, made the linkages between large banks The policy discourse that followed made few remarks on The policy debate that followed the Treaty concerned the limited mandate given to the ECB in Maastricht and development of the SGP.

Not far into the millennium, some explicit attention was given to financial stability. On demand from ECOFIN the EFC was asked to examine "whether the existing regulatory and supervisory structures in the EU can safeguard financial stability" (EFC 2000: 4). Ad hoc working groups of the influential EFC delivered two reports on financial stability and financial crisis management respectively. The first Brouwer Report (EFC 2000), named after the chairman, examined the institutional arrangements for financial stability. Addressing financial trends, emphasis is put on the benefits of technological progress and deregulation (EFC 2000:11-2). Financial innovations, such as derivatives, have increased the efficiency of global financial markets and allowed for the reallocation of risk. The report spends no more than four sentences on challenges with these developments, and argue for a transparent and liquid market and "as banks' assets have become more liquid and marketable, one application could be that the likelihood of liquidity problems is

reduced" (ibid: 12). The financial crisis proved that liquidity risk remains a real problem.

In relation to increasing cross-border banking activity in Europe, the EFC express concern that the emergence of financial problems at a major cross-border financial group could have contagion effects in other member states. The report stresses the need to address this issue. However, the report also stressed the position of the home country principle as the basis for supervisory arrangements. This is a contradiction. Awareness of cross-border banking challenges should be meet with co-responsibilities between home and host supervisors or a macro bases supervisory arrangement. However the report concludes that:

> *"The existing institutional arrangements provide a coherent and flexible basis for safeguarding financial stability. No institutional changes are deemed necessary" (EFC 2000: 7).*

Despite addressing pressing issues of systemic character, the recommendations for enhancement set out in the report only concerned the practical functioning of institutional arrangements (ibid: 7-8) and these are to be handled by non-legally MoUs (ibid: 19). As we shall return to later (section 5.3), non enforceable arrangements decrease in value as the costly effects of financial distress intensifies. The recommendations of the report to strengthened coordination of supervisors and central banks was partly meet by the establishment of a non-legally agreement on cooperation and exchange of information between supervisors and central banks (ECB 2003).

The mandate of the second Brouwer Report (EFC 2001) was to examine the arrangements for crisis management in the EU. It addressed different stages of management during a crisis and the policy responses at hand. Discussion of these issues remained rather general. The report stressed as a general principle the involvement of private institutions as much as possible in crisis prevention (EFC 2001: 11). This micro based philosophy became a main component of the regulatory regime that developed in the mid 2000s. Concerning supervisory efforts, the report further advocated sharper focus on more risk-sensitive capital requirements that are linked to credit, market and operational risk (ibid: 12). Attention to adequate internal controls and risk management of banks is desirable. Yet, in its recommendations, like the first Brouwer report, the EFC ignores liquidity risk that can arise from markets. In fact, the financial crisis in 2007-8 was a liquidity crisis to begin with.

The report praised that "more proactive supervision" would be reinforced by wider

public disclosure, which in turn enhances market discipline and increases "incentives for prudent policies of financial firms" (ibid). Transparency is desirable, albeit it needs to be complemented, instead of putting supervisors and regulators on "shoulders-length". Reliance on market discipline to make banks seek prudent capital requirements is built on a belief of market actors as rational. This will be touched upon in depth below (5.1.3).

Regarding crisis management procedures, the EFC acknowledges that relevant EU directives impose no obligations of for information sharing in a crisis situation (2001: 15-17), and the importance of ex ante agreements for effective co-ordination of supervisory measures. Despite this, it ignores legally binding solutions, and advocates further development of existing MoUs (ibid: 16). Although rarely debated in relation to crisis management, financial supervision received some attention as banks got involved in more cross-border activity. No macro prudential supervisory proposals were discussed extensively. ECBs considered the arrangements for supervisory cooperation to be enhanced and "should enable us to effectively address the financial stability challenges lying ahead" (ECB 2005b). Emphasizing an evolutionary approach, the institutional set-up, in the words of ECB vice-president Papademos, should "be given adequate time to show its effectiveness before alternatives are considered" (ibid). Indeed, adequate time was given.

Prepared during the severe tensions in the interbank market in August 2007 (ECB 2010a), the EFC (2007) presented the final report *Developing EU Financial Stability Arrangements* the following month. Despite the depressing financial outlook at the time, the report concluded that:

> *"The probability of a large scale cross-border financial crisis in the EU is low"* (EFC 2007: paragraph 3).

The optimism aside, the report expressed need for clarification and strengthening of the regulatory framework to ensure that options in managing crisis become available and operational in a cross-border context. Although, suggestion on a pan-European supervisory authority was left out, the report suggested that national mandates of national supervisors should include "a requirement to cooperate and take into account the financial stability in all Member States" (ibid: paragraph 12). This could be interpreted as a concrete step away from the home country principle, and awareness of cross-border challenges.

5.1.2 Leave it to the market: the rational actor and market discipline

In line with Pillar 3 of Basel II, the CRD introduced market discipline as a "second line of defense" for stability in the Eurozone. Developments on the CRD closely followed the progress of Basel II. However, prior to detailed announcements on Pillar 3 by the Basel Committee, the Commission emphasized the importance of disclosure to enhance market discipline (CEC 2001: 56-63).

> *It can be expected that sound practice disclosures will strengthen market discipline with potential additional positive effects such as an improvement of an institution's market strategy, its risk control and its internal management organisation, all of which are essential to the revision of the capital framework* (CEC 2001: 56).

The Consultative Document emphasized the work of the Banking Advisory Committee (BAC) and its "nine capital review-dedicated technical working groups"[17]. The BAC is highly influential committee of central bankers, whom the "European Commission has never proposed measures which were not in accordance with the majority view of the BAC" (CEC 2000b: 5). It is likely that the technocratic workings of the BAC were influential in shaping the Commissions belief in what constitutes sound and prudent policy.

Briefly repeating my self, market discipline involves relying on market mechanisms to discipline financial institutions in order for them to manage their risk properly. This is to be achieved through transparency. By disclosure of bank information such as capital levels, risk profile and internal risk assessment process, the markets is meant to evaluate the condition of the bank and subsequently react to its behavior. This regulatory philosophy is built on the belief that market actors are rational and able process (all) available information. This belief was strongly evident in the recommendations of the Commission:

> *"Well-informed market participants are able to take rational decisions. To that end, they need data that provides them with the necessary factors relevant for the assessment of the financial performance of an institution. In particular, this entails the ability of the markets to obtain a clear picture of an institution's risk profile."*(CEC 2001: 56).

This constitutes one of the key assumptions of neoclassical economics (in general) and the EMH and rationality hypothesis (in specific). That fully informed, rational actors respond to changes in demand and supply and thereby move the economy or a specific market back towards equilibrium. What is challenging with market discipline is that it rests on a notion that markets are more efficient and well functioning than they really are. For market

[17] Minutes from BACs working groups are not published.

discipline to function market actors must be fully aware of what is happening in the market, they must be able to process the (relevant) information and finally be capable to act on the information.

The rationality of market actors, especially during financial distress, has been challenged by a range of scholars in the field of economics, history and psychology. Leading contributors within psychology (e.g. Kahneman and Tversky 1979; Tversky and Kahneman 1982) has questioned human judgment and decision-making under uncertainty, and actor's ability to process large amount of information. As was shown in subsection 2.2.5 and 2.3.1 there is a substantial amount of research that demonstrates how collective euphoria during economic up- and downswings may affect the rational actor. Dating back to Keynes (1936), scholars with training in history (Kindleberger 1989; Galbraith 1955, 1993) and economics (Minsky 1982, 1986; Shiller 2005) have demonstrated how psychological factors ("animal spirits") plays in during booms (optimism) and busts (panic), resulting in irrational behavior. Despite academic appraisal[18], writings in this "alternative" economic tradition seem to have fallen short of reaching or at least influencing EU policy-makers and regulators.

Limitations of market disciplines´ theoretical foundation aside, developments in financial services and parallel legislation across Europe may have further challenged the ability of rational and well-informed investors, consumers and stakeholders to discipline banks. Developments and growth in financial services, especially securitization and financial derivatives, added complexity to the European financial system. Securitization is a process were financial institutions transfer loans off their balance sheet, and sells them on to investors. In this process, different loans (with differing credit rating) are combined, then separated into bonds and sold on to investors or consumers. As these loans are transferred of the banks balance sheet, they are no longer a part of the regulatory capital requirements. This might bring further uncertainty to a banks risk profile, uncertainty that can misinform market actors. Financial derivatives are another financial innovation of complicated character. Simply put, a derivative is a contract where the contract holder has obligated himself to buy (or sell) a financial instrument in the future. The purpose is to hedge or

[18] Daniel Kahneman earned the "noble prize" in economics (alongside Vernon Smith) in 2002 on his work on human judgment under uncertainty.

mitigate risk[19]. Private trade (over-the-counter) (OTC) of these derivatives in Europe and globally has increased fast the last decade or so (Helleiner 2011). Being both opaque and "futuristic", evaluation and monitoring of this part of the financial sector is difficult, and subsequently challenges the functioning of market discipline.

Parallel to these developments, other domains of the financial sector underwent legislative change. The MiFID allowed for a range of new (OTC) derivatives to be traded across borders (Jackson 2009: 33). With these developments at hand, EU policy-makers and regulators reliance on disclosure and market discipline to regulate banks seemed at least optimistic.

5.1.3 What the Stability and Growth Pact didn't say

In general, sound public finances and fiscal discipline help curb public debt, which reduces the interests on public debt, which in turn allow for restructuring of government spending. Hence, a higher share of public money is available for political and economic purposes. The purpose of the Stability and Growth Pact (SGP) was to maintain price stability and sound public finances within the Eurozone. The impetus of the Pact was the German concern (Waigel 1995, Federal Finance Ministry 1995) that other member states would act fiscally undisciplined once they had granted Eurozone membership.

> *"For a successful EMU, however, the fundamental financial policy solidity must be guaranteed in the participating states"* (Federal Finance Ministry 1995: paragraph 4).

The workings of the Commission's Monetary Committee (CEC 1996a, 1996b, 1996c) on the SGP in 1996 reflected the German view and stressed the importance of sound government behavior and limits on sovereign debt burdens. The SGP represented the only collective crisis prevention mechanism in EMU prior to the crisis. Implicit in the institutional arrangements of the SGP there is an assumption that governments, not (financial) markets, are the fundamental problem. If governments prudently apply and follow the budget limits and debt rules, then system stability would prevail. This line of reasoning is comparable to the view of neoclassical theory on government intervention in the economy as the source of market distortion (e.g. Friedman 1962).

[19] For instance, in order to ensure predictability of future earnings, a rice farmer may sign a contract to sell a quantum of rice (with a price attached) at a future time.

The Monetary Committee stressed that a budgetary target for EMU as a whole would function as a "fiscal anchor", and increasing "visibility and transparency, would foster surveillance by the market" (CEC 1996b: paragraph 11.3c). In retrospect, it seems that the institutional arrangements overrated the markets ability to monitor and discipline. This is partially explained by the inefficiency of capital markets and that moral hazard can lead to inefficient risk pricing (De Grauwe 2009: 233-4). Lets draw upon the present crisis to illustrate this point. Greece is on an unsustainable debt path. If the capital markets were to function efficiently, it would identify the debt problem as a Greek problem, and in turn the market would attach a certain risk premium to the Greek government debt. For the sake of the argument, lets assume that there is a possibility that the lenders find it challenging to attach the correct risk premium. They assume that if there is a serious debt crisis – Greek default – other member states will "bail-out" Greece to avoid spillover effects (e.g. foreign financial institutions that hold large amounts of Greek bonds). Hence, a Greek default, may lead to default of financial institutions, which in turn may create a general debt crisis; dynamics described in subsection 2.1. Attempts to avoid this include governments and lenders of last resort (e.g. ECB and IMF) buying Greek bonds. Such an implicit "bailout" guarantee may lower the risk on premium on Greek bonds, and thereby capital markets fail to attach the correct price on risky Greek debt instruments.

Another shortcoming of the design of the SGP, which arguably demonstrates selective learning, relates to crisis management. The SGP was to be respected "even in unfavourable economic circumstances" (Buti and Sapir 1998: 15). It seems that the policy-makers behind SGP failed to recognize the unfortunate relationship between budget limits and the need for government intervention and increased spending during a recession. During economic hardship, members of monetary union (in general) lack the option of devaluating their currency, and (specifically) in the EMU a centralized European budget for transfer. Thereby national government budgets become the nation states' only tool to confront asymmetric shocks. Rigid numerical deficit rules at the expense of budgetary flexibility may hinder governments to use automatic stabilisers efficiently under asymmetric shocks and during recessions. This might increase the pressure on the ECB to relax its monetary policy. This is a paradox, since SGPs aim was to protect ECB from political pressure, when in fact it may have increased pressure. (De Grauwe 2009: 245). The crucial need for robust government intervention and increased spending during recessions has been advocated for long by economists affiliated with the Keynesian-school of thought. In fact, the SGP was

sat aside during the critical stages of the financial crisis in 2008-9 in order to let automatic stabilisers function (Underhill 2011).

5.1.3.1 The causal primacy of private debt

The Monetary Committee's (1996b, 1996c) strong emphasis on sound government behavior and public debt as the source to Eurozone-stability fails to recognize, at least address, the inherent instability of liberalized financial markets (Minsky 1982, 1986) and the devastating effects private debt can have during financial turmoil. A pressing point to be made is the fact that private debt is not mentioned by a single word in the SGP, nor did any alarm bells go off as private debt levels accumulated prior to the crisis. Lack of concern regarding the accumulation of private debt is often referred to as the "Lawson doctrine"[20]. The doctrine states that a large current account deficit is not a concern if the fiscal accounts are balanced. In the words of an exponent of the doctrine:

> "[A]n increase in the current account deficit that results from a shift in private sector behavior – a rise in investment or a fall in savings – should not be a matter of concern at all" (Max Corden cited in Edwards 2001: 9).

The theoretical foundation of the Lawson doctrine can be linked to the fundamental logics of the EMH: that claims that free markets provide efficient allocation of resources. Private debt is simply a result of the functioning of private markets. If flows of capital to Spain and Ireland take place, it is because that is where the best returns are. The market knows this; otherwise people would not invest in the Spanish and Irish markets.

Since the start of the sovereign debt crisis, dated to the "Greek trigger" in December 2009[21], casual explanations have emphasized government profligacy. Fair enough, since there is a substantial relation between a countries public debt levels and its solvency status. However, a strong argument can be made that the root cause of the debt problems in Europe was the lack of attention concerning the accumulation of unsustainable private debt. Paul De Grauwe (2010a: 2) provides us with some evidence (presented below in Figure 7 and Figure 8).

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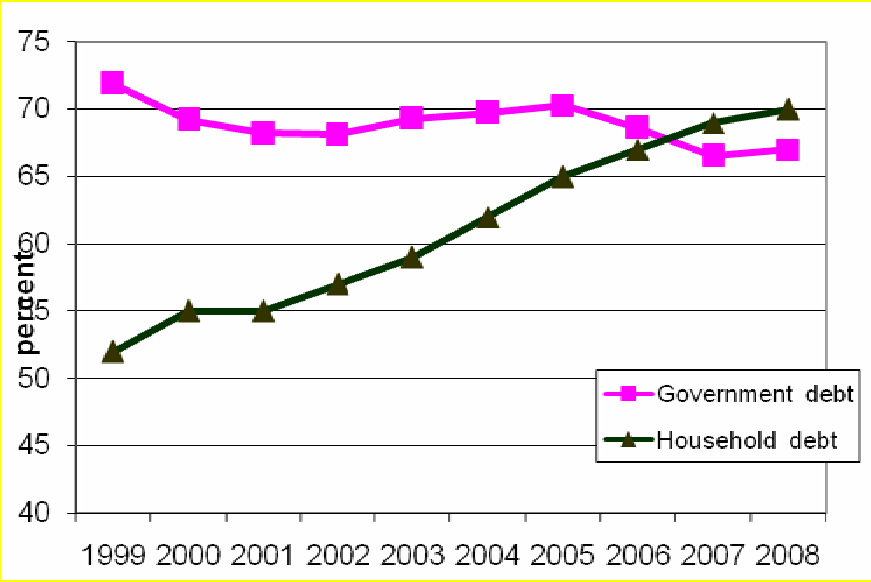
[20] Named after Nigel Lawson, former Chancellor of Exchequer who articulated it in the 1980s (Blanchard 2006).

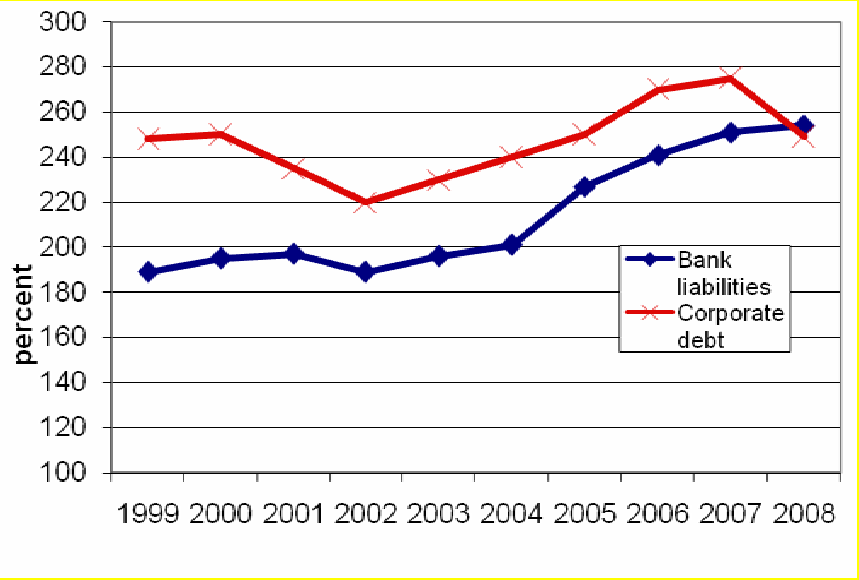
[21] In December 2009, only a year or so after the peak of banking crisis, worldwide attention shifted towards Athens. Minister of finance Sachinidis admitted that Greece´s debt had reached 300 billion euros – the highest in modern history (BBC 2009).

Figure 7 Household and government liabilities in the Eurozone (% of GDP)



Source: European Commission, AMECO database and CEPS.

Figure 8 Bank and corporate liabilities in the Eurozone (% of GDP)



What these two figures show us is (1) that household and bank debt levels where increasing very fast prior to the bank and debt crisis, and (2) that the only sector that did not experience an increase in debt level was in fact the government sector. In fact while the government debt ratios of the Euro Area declined from about 72% in 1999 to around 65% in 2007, in the same period household debt increased from around 50% to 70% of GDP (Figure 5.1) and the debt of financial institutions leaped from less then 200% to above 250% of GDP (Figure 5.2).

Accumulation of private debt in the Eurozone, alongside the extended effects of the American sub-prime crisis crippled Europe and debt-deflation like dynamics – as described by Irving Fisher (1933) – where set in motion. Fisher occupied with the financial turmoil of his time – the Great Depression – observed that if the price of goods decline faster than debts are reduced, the real value of private debts would increase over time[22]:

> Each dollar of debt still unpaid becomes a bigger dollar, and if the over-indebtedness with which we started was great enough, the liquidation of debts cannot keep up with the fall of prices which it causes. In that case, the liquidation defeats itself. While it diminishes the numbers of dollars owed, it may not do so as fast as it increases the value of each dollar owed. Then, *the very effort of individuals to lessen their burden of debt increases it, because of the mass effects of the stampede to liquidate in swelling each dollar owed* (1933:344, his emphasis).

Fisher argued that the cause of all great depressions appears to be over-indebtedness soon followed by deflation, and if any "other factors to become conspicuous, they are often merely effects of symptoms of these two" (1933:341). As debt-deflation dynamics struck the private sector in Europe (De Grauwe 2010a: 1), Eurozone governments where forced to let their own debt levels increase. This came about in two ways (De Grauwe 2010a, Underhill 2011): (1) governments took over private debt (mostly from the banking sector) and (2) as the economy is driven into a recession, government revenues decline and social spending increases. Efforts to encounter these debt levels are further strained by EMU-membership. A common currency reinforces the debt problems. Outside the euro, competiveness could be restored through an external devaluation, reducing its national currency rate. Inside the Eurozone, enhancing competiveness involves an internal devaluation; lowering wages to increase exports and decrease imports. With that, the purchasing power and tax revenues of the government are weakened. Consequently, Fishers debt-deflation dynamics start to operate. It is a paradox that cut in public spending

[22] Imagine that you borrow a million euros to buy you're dream house (with no money behind). The house is worth a million euros; you owe a million euros. Deflation kicks in, and prices plunge across the economy: along with the price on the dream house, you´re salary decline. Now everything cost less, but everyone has less money. Unfortunately for you, the real size of you´re mortgage has increased: a million euros´ worth of debt is now a bigger burden than it was previously. The dynamics of "sticky wages" are left out of this little story.

and wages – as forced upon Greece – actually may lead countries further away from goals of lowering debt sovereign debt as percentage of GDP. Because even though growth in debt levels becomes lower, GDP shrinks, so that debt compared to GDP still increases.

The idea of government behavior and public debt as the precondition for stability in the Eurozone is arguably misleading, at least not sufficient. As demonstrated above, the role of private debt, and hence the actions of market actors, should be addressed more extensively. Spain and Ireland, in particular, illustrates the connection between public and private debt and crisis. Prior to the crisis both Spain and Ireland was successful in reducing their government debt to GPD ratios. Between 1998 and 2007, Spanish and Irish government debt as percentage of GDP, decreased from 57% to 26% and 53% to 12% respectively (Stein 2011: 201). In addition, these were the two countries, which allegedly followed the rules of the SPG better than any other member state (De Grauwe 2010b). In the same timespan, private debt levels in Spain and Ireland increased heavily (Stein 2011). The consequences of the latter development would prove immense for their economies (and the Euro Area in general). The extensive growth of the Irish banking sector (see Figure 4), had granted it too-big-to-fail status, and when the financial crisis struck in 2008, it was considered a necessity to save the financial sector. The government's decision to guarantee for $574bn in the banking system (Smedshaug 2011: 165), morphed the Celtic-banking crisis into an Irish sovereign debt crisis. The struggle to contain domestic private debt was evident in Spain as well. At the time of writing (May 2012), Spain has entered the center stage of the debt crisis in Europe and commentators contemplate whether its too-big-to-save status endangers the existence of the Euro Area. Not surprisingly, adding bailout of the banking sector to astronomic stimulus packages and reduced tax revenues, government debt burdens scream default.

5.2 Industry presence in Brussels

Hypothesis II: An asymmetrical organization of interest structure enabled the financial industry to mitigate prudential regulations that could have guarded the EMU against and prepared the EMU better for, a financial crisis.

Having examined the role of ideas and expert committees in shaping the regulatory philosophy of EMU, we now turn to the presence of interest groups in the policy-making process: the interaction between regulators and the financial industry. This section

examines how the interest structure of financial regulation favors the financial industry and how their representatives participated in the policy-making process of key financial directives.

When designing this study, methodological challenges (see subsection 3.3) with exploring interest group influence piled up. As the research progressed, it became evident that these methodological concerns were truly valid in a European context. Seemingly, not as opaque as the making of Basel II (Underhill 2011: 118), lack of transparency characterized large parts of the policy-making process on financial regulation in the EU. The Lamfalussy framework (Figure 6) brought some transparency to the policy-making process, yet the positions of key actors are often absent. Minutes from EFC or CESR meetings with market participants are rarely published. The website of different EU agencies is constantly updated, however not always for the better. As committees are reformed and renamed, information concerning their predecessor is often removed. For instance, position papers and working documents of the Banking Advisory Committee (BAC) was removed, as the BAC was replaced by the European Banking Committee (EBC) in 2004. The same goes for revised directives. After new amendments were included to the CRD, the original proposals and several position papers were removed.

Despite transparency issues and absence of desirable data we are able to draw some inferences on the financial sectors' influence on EU legislation concerning financial markets. The main findings concern consistency between bank interests and financial legislation, and the increasing intimacy between policy-makers/regulators and the financial industry, and their specific role as "experts".

5.2.1 The role as expert: Asymmetrical interest structure reinforced

The financial industry - represented by lobby groups - has a long track history for participating in policy-making processes in Brussels. As discussed in subsection 2.3.2, the technicality of regulation issues and the vast resources of financial elites create an asymmetrical organization of the interest structure in financial regulation. Suffering from collective action problems and limited material resources a natural counter-lobby part (e.g. consumers) to the financial industry barely exist. The participation of consumer organizations in consultations process on financial legislation at EU level is limited (IIMG 2007). The "highly technical nature" of regulatory issues is believed to explain the lack of involvement (ibid: 11).

Institutional developments at the turn of millennium reinforced this asymmetry. In the early 2000s, the formal policy process format in Brussels, regarding financial services, underwent serious changes. Through the Lamfalussy Framework consultations between policy-makers and market participants was formalized. The Process (Figure 6) involves two consultation periods where the financial industry is taking part in the legislation process. On level 1, where framework principles of the directive/regulation are formed, the Commission formal proposal is based on a full consultation process. Technical measures are implemented on level 2, after the Committee of European Securities Regulators (CESR) has consulted the industry. The Process brought a new level of transparency, along with new opportunities for the participation of non-state organizations in the world of financial market regulation. The presence of the industry was, according to the "architects" of the framework, of great importance. In the words of the Committee of Wise Men*;*

> *"market practitioners must be involved…at every level…in a continuous process…with particular weight given to those with knowledge and expertise on the subject in question" (Lamfalussy 2001: 32-33).*

The new institutional structure favors the financial sectors in at least two ways. The first concerns advantages with "free-seating" in Brussels. Being granted *access* to the table without relying much on material resources is surely desirable. Already well-organized and resourceful lobby organizations are then able to skip traditional lobby steps (gaining access). Previously "tied-up" resources can now be used on substantive policy proposals or extensive campaigns against unfavorable regulations. This arguably strengthens the position of the financial industry to influence the policy-making process.

The second regards the *status* of the financial sector during consultations and negotiations. Perceived and invited as "experts" implies that proposals from the industry are considered important and worth taken into consideration. In a way this contributes to legitimizing the stance of the financial sector. Traditionally there are special interests associated with financial industry proposals. However, with the role as expert comes a shade of neutrality. Now during negotiations and consultations, the financial industry is perceived as sharing its knowledge and insight on technical regulations issues for the general good. The intimacy between regulators and financial industry "experts" is arguably favoring the financial sector, as the ability to articulate policy proposals in line with their preferences is enhanced.

The relationship between policy-makers and the financial sector in developing financial legislation is continuously appraised. Subsequent to a range of consultation papers on different directives, the Commission has emphasized the importance of comments and recommendations of market participants. In a feedback document to the third consultation paper on capital requirements, the Commission explicitly states that it will "introduce changes to the draft proposals in light of the comments received" (CEC 2003: 2). The mere number of respondents in the consultation processes shows the activity of the financial industry. For instance, the responses to the Commission third consultation paper (CP03) on capital requirements in 2003 were "significant" and included 128 contributions from associations and participants of the financial industry (CEC 2004: 2). Having documented the presence and activity of the financial industry, yet little is said on concrete influence of interest groups.

5.2.2 Some indicators of influence

Looking from the outside and in, one could argue that the pre-crisis financial regulation in Europe is to a large degree consistent with the interests of the financial industry, in particular large investment banks. As documented in chapter 4, the regulatory regime relied heavily upon banks themselves to manage risk and estimate capital adequacy levels. This is partially consistent with key preferences of the financial sector[23] emphasizing self-regulation, less intervention by the state and a principles-based, flexible approach to regulation. However, in an attempt to draw some inferences on whether this consistency is interest group driven we need to look at the consultation process more closely.

The main method applied concerns "assessing the degree of preference attainment" (Dür 2009). This is done by examining legislative drafts (t_0) and position papers of the financial sector (t_1) and comparing it to the final legislation (t_2). If the preferences of lobby organizations are present in final legislation it can be interpreted as an indication of influence. This method is obviously not unproblematic (see subsection 3.3). Examining several consultation papers and their respective responses a patter occurs. Concerning fundamental issues (principles) of the directives, there is a large degree of consistency between early consultation papers and responding position papers by the industry. For instance, early drafts by the Commission (CEC 2001, 2003) on private risk management and market discipline - two core pillars of the CRD (and Basel II) - are truly consistent with industry preferences (BBA & LIBA 2003, 2004). This could cautiously be interpreted at

[23] See subsection 3.3

least two ways: (1) that regulators have been exposed to informal lobby efforts prior to the publication of the consultation paper or (2) that the regulators share the preferences of the financial industry, which could imply a regulatory capture. Based on the fact that lobby take on informal channels and the *intimacy* between financial sector experts and regulators, both interpretations are likely, although it is hard to demonstrate which is at work.

In some instances the consistency seems to be a result of concrete dialogue. In a response to CEBS (2004) consultation paper on the supervisory review process (SPR), the BBA and London Investment Banking Association (LIBA) expressed satisfaction to see that many of the points they themselves had raised in dialogue with regulators were included (2004: 2). These points were related to a risk-based framework and the principle that it was the responsibility of the firm to define and develop its Internal Capital Adequacy Assessment Process (ICAAP).

Discussed above, as experts the financial sector has been granted access in the policy-making process without making substantial (traditional) lobby efforts. However, this is far from equivalent to concrete (and consistent) influence on policy outcomes. The empirical finding indicated that struggle characterizes the financial industry´s engagement with regulators and policy-makers at the EU level. During the development of the CRD, large (mainly British) banks with cross-border activities emphasized the establishment of a "lead supervisor" (BBA 2003: 8; BBA and LIBA 2003: 2) with more decision-making authority than the "consolidated supervisor" proposed by the Commission (CEC 2003). Cross-border banking groups expressed dissatisfaction with a consolidated supervisor, due to concern that their activities would face more than one interpretation of the Directive, thus duplicating compliance costs (BBA 2003: 38-9). The concept of lead supervisory was in the end, opposed by national supervisor, who feared that the arrangement would dilute their powers (interview in Quaglia 2010: 57).

An opposite case, were the financial sector was able come through, concerns calculation of capital requirements on different levels of financial groups (Quaglia 2010: 58). The Commission advocated a "consolidated" model that allowed regulation and supervision to be applied to the top tier (parent company) of the group, including all members that provided financial services. British banks (BBA 2003: 36-7) wished to include a "solo" model to remain a "possibility in the UK by virtue of EU legislation". The "solo" model would isolate the regulated entity from other members of its group. Inclusion

of the "solo" model was achieved after intensive lobby efforts towards both the Commission and EP (interview in Qugalia 2010: 58).

"Black-box" issues make verification of concrete lobby influence on policy outcome difficult. However, some observable dynamics indicates favorable terms for financial sector influence. The dual attendance of the industry, as experts and interest group, enhances the position in the policy-making process. Arguably, the former position allows the financial industry to shape the regulatory dialogue and give (credible) "expert" advice in line with sector preferences.

5.3 Institutional dynamics

The previous sections (5.1-5.2) emphasized the role of ideas and interests, and examined how the intellectual foundation of expert groups and preferences of the financial industry affected policy-making and consequently the regulatory regime of the EMU. We now turn to institutional dynamics that seems to have constrained the policy-making space, explaining why common pan European regulations and ex ante crisis management procedures have yet to be a part of the EMU design.

The reality in Europe when financial distress spread in 2008 was that financial regulation was designed at EU level (although national discretion prevail when it comes to implementation), whereas financial supervision was left to national authorities. In hindsight, and demonstrated in previous sections (2.2.5 and 4.2-3), this micro based arrangement revealed shortcomings and proved unsatisfactory both in preventing and managing financial crisis. This subsection, guided by the hypothesis below, seek to illustrate some institutional dynamics that may have constrained pan-European or macro-based regulatory and supervisory arrangements.

5.3.1 Battle of the systems

Hypothesis III: Varieties of national financial systems constrained possible agreements on pan-European arrangements for financial regulation and supervision, that could have made the EMU better prepared for a financial crisis.

Above (5.2), the financial sector in Brussels was treated as a unified actor. However, there are also competing interests within the financial sector, expressed through national governments. These competing interests reflect the institutional structure of their domestic financial system. For analytical purposes we can distinguish between three different

financial systems: the liberal, the coordinated and the more ambiguous category: Mediterranean (Hall and Soskice 2001: 19-21). Fairly accurately the UK represents the liberal system; the German and the Dutch system resemble the coordinated; and as the name indicates the Mediterranean system include France, (Italy and Spain). In the coordinated financial system there is a close relationship between finance and production (bank and business), financing takes place through loan from banks and short-term profitability is less important. The liberal system rely more on the stock market for financing, it involves many investors and short-term profitability is important (ibid: 19-32). These institutional differences in turn make up system specific firm preferences. Naturally government authorities (as well as national lobby organizations) will push for financial regulations and supervisory arrangements that favor firms in their jurisdiction. For instance, UK officials are mainly concerned with the comparative advantage of the City of London.

Story and Walter (1997) spoke of "the battle of systems" pointing to the intergovernmental character of negotiations on financial market regulation in the EU in the 1980s and early 1990s. Empirical findings indicate that similar "battles" were present in the 2000s. One specific incident concerns the design of the MiFID. The main objective of the Directive was to enhance cross-border competition between firms and exchanges in the European financial markets. In late 2000, the Commission issued a communication on limitations with the ISD, suggesting an ending to the "concentration rule" (CEC 2000a). The concentration rule allowed all EU members to require that all investor transactions were to be executed on a regulated market (stock exchanges). This proposal favored the liberal system over the Mediterranean; considering that, historically, the UK system has been dominated by investment firms, whereas the French system have centered on stock exchanges (Macartney 2009: 472). Member states such as Spain, Italy and France, all had laws that stated that securities dealing had to take place through the stock exchange. The "Mediterranean" coalition, in contradiction to UK and German Banks, strongly opposed the Commissions proposal. Extensive regulatory diplomacy on part of the Southern states ell short as the final reading of MiFID ended the concentration rule. This favored UK and German banks, which had no such rule in place, as well as global investment banks that performed such operations internally (Quaglia 2010: 86).

Many of the legislative proposals set out in the Commissions FSAP revealed tensions between the principles-based the liberal system and the more rule-based Mediterranean system. The "Lamfalussy directives" (see footnote 12) moved away from

minimum standards based on the principle of mutual recognition, and emphasized maximum harmonization of regulation through more complex directives and laws. This approach conflicted with the liberal system, in particular with the functioning of the "light-touch" regulatory regime of the UK. Extensive efforts were made by representatives of the UK system (public and private) to smoothen out regulatory reforms. Dissatisfaction was expressed as the Corporation of London established an office in Brussels to "act as en "early warning radar" on these issues" (Buller and Gamble 2008: 267-8).

Why does this matter for pan-European arrangements? Well this is meant to illustrate how institutional varieties in financial systems give rise to political struggle over different regulatory approaches. Thus, adding difficulty to agreeing on a common financial regulatory and supervisory framework.

5.3.2 Political feasibility constrains crisis management

Hypothesis IV: National institutional diversity can explain the lack of ex ante crisis management procedures and explicit burden sharing routines on EMU level.

By ex ante crisis management procedures I mean legally binding and clear division of responsibility, information co-ordination and burden sharing. Instead, the empirical analysis in chapter 4 gave an account of; a European crisis management regime that was based on "improvised co-operation" and the principle of decentralization. Through non-legally binding MoUs (ECB 2003), crisis management rested on national governments ability to co-ordinate information exchange and burden sharing in case of cross-border banking crisis situations. The reliance on ex post negotiations on co-ordination and burden sharing is arguably suboptimal as time is of the essence during financial turmoil. Empirically, can this be linked to institutional dynamics? The empirical research to some extent supports the hypothesis above. Yet the empirical findings are ambiguous. First of all, the debate on EMU level on ex ante crisis management and burden-sharing arrangements is limited. The fact that crisis management arrangement in general fails to make the policy agenda can be seen in relation to what was discussed in section 5.1 that EMU authorities and elites to a limited extent envisioned a cross-border banking crisis. The reason that little emphasis is given to burden-sharing mechanisms could be due to political feasibility. To many member states the issue (fiscal transfers) is of sensitive character, and proposals on EMU level would most likely fall short of national opposition. Regarding economic institutions, the member states of the Eurozone are not a homogenous group. The growth models of Spain and Portugal do not resemble that of Germany and the Netherlands. Social

policies and welfare arrangements in Denmark and Sweden are not comparable to does in Greece and Italy. UKs financial system is unlike the French. Differences in economic structure give rise to diverging economic policy preferences. Burden sharing in the shape of a common crisis fund for instance, involves fiscal transfers from member states to the EMU level. This again, involves intervention in national fiscal policy and taxation, which is a more sensitive, or "sticky" political issue. Diverse national preferences can contribute to explain why the EMU lacked independent capacity to engage in cross-border bank rescues or member states facing sovereign default. Although limited, the debate on burden-sharing mechanisms was not non-existent. During Maastricht and the years that followed, initiatives and concrete proposals involving fiscal transfer mechanisms was advocated by academics and policy advisors affiliated with the Commission. However, as we shall see below, the policy initiatives fell short of success. Political feasibility and national preferences, with Germany in front, can provide some explanation.

During the treaty negotiations that took place in the early 1990s, the Commission proposed the creation of "a specific financial support scheme which would be activated when major economic problems arise…" (CEC 1990a: introduction). This idea was evident in a later treaty draft by the Commission were proposed appropriate instruments for the Community included "a specific financial support mechanism which will be brought into operation in the event of major economic difficulties in one or more Member States…" (CEC 1990b: paragraph 4(iii)). No such mechanism was included in the institutional arrangements set out in the Treaty. Not long after Maastricht, Commission supported research (Italianer and Vanheukelen 1993; Italianer and Pisani-Ferry 1994) proposed a scheme for fiscal burden-sharing. Again it turned out to be too controversial to be "seriously discussed" by member states (Schelkle 2005: 386). As noted earlier (4.2.2), especially Germany opposed transfer mechanisms that could provide cushion to distressed cross-border banks or member states at risk of sovereign default. In particular, German officials stressed the primacy of the so-called "no bailout" of member states clause (Art 104 TEU 1992) to the ensure stability of the Community (Federal Finance Ministry 1995).

> *"...Article 104c is thus the external framework within which national financial policies are basically free to move without seriously endangering monetary union. However, it must be ensured that the stability framework also holds under extreme pressure and that the participants in monetary union at all times comply with the treaty requirements"* (Federal Finance Ministry 1995: paragraph 5).

Although not as bombastic, opposition was present in Scandinavia as well. Swedish authorities acknowledged that:

> "there are *economic* reasons for a system of transfer payments among the member states…But, at the present, the *political* arguments against such systems are very strong" (Calmfors et al. 1997: paragraph 7, their emphasis).

Similar tensions were present when the framework of the SGP was heavily debated in 2003-5. Although the criticism mainly concerned the "one-size-fits-all" deficit rule and not crisis management per se, radical policy reforms included proposals on "rainy-day funds" (Sapir Report 2003: 137; Buti et al. 2003: 26). Strong opposition to reform came from the German Bundesbank that emphasized that the key problem with the SGP was not its design, but its implementation (Deutsche Bundesbank 2005). This position gained great support from both Austria and the Netherlands (Dyson and Qugalia 2010b: 536). However, Bundesbanks stance conflicted with the view of the German Chancellor at the time, whom in a letter to the *Financial Times* expressed that

> "Reform of the European stability and growth pact is a key issue" (Schröder 2005).

In the end, SGP reform left the question of fiscal burden-sharing mechanisms open. Beyond the scope of the thesis, these dynamics were present in post-crisis Europe as well. Extensive reform is more likely to take place after a crisis than in normal times. So as the financial crisis intensified in late 2008, not surprisingly, concrete policy reforms emerged. Most notably, French officials proposed the establishment of a European Rescue Fund, financed out of the budget of member states (Lagarde 2008). The progress on this was limited, and hampered by rulings of the German Federal Constitutional Court in June 2009; which effectively ruled out moves to fiscal union without far-reaching Treaty changes (Dyson and Quaglia 2010b: 24).

This brief account to some extent illustrate how the diverging national preferences of key actors can affect policy-making at the EMU level, and how the sensitivity of some policy issues constrains common pan European solutions. For instance, agreements to pool tax revenues to make EU level authorities more credible in financial stability issues. The discussion does manage to show the multi-level and strong intergovernmental dimensions of the EU system. Nonetheless, the empirical findings remain too limited to explicitly claim that the hypothesis set out above is strengthened.

6 Concluding remarks

Financial crisis have many causes and few clear-cut explanations. However, in the end most crises are the result of some form of regulatory failure. Given that financial regulation is ultimately about politics, explanations to financial crises can be found in policy-making processes.

The aim of this study has been to examine explanations to the development of the pre-crisis regulatory regime in the Eurozone, and thus seeking to explain the lack of preparedness for financial crisis. Through process-tracing and document review the analysis has identified three different causal explanations that may have contributed to the insufficient design of the regulatory regime. The first concerns ideational factors. The selective use of economic theory by expert committees seems to have contributed to a biased micro-oriented regulatory philosophy. Economists and policy-makers responsible for designing regulatory policy in the EMU, has emphasised to a large degree markets and banks ability to calculate and evaluate risk. This was to be achieved through private risk management and market discipline. The idea that, if individual banks were kept safe, system stability was secured, fails to address endogenous risk in the financial system. The micro-oriented regulatory regime was ill equipped to recognize increased system-level risk, due to deeper financial integration and growing large cross-border interconnected financial institutions. The idea that government behaviour, not markets, was decisive for the functioning of the EMU, was dominant amongst policy-makers, all the way back to the planning of the EMU in the late 1980s. This overemphasis on governments and public debt could constitute a lack of intellectual preparedness for financial crisis, as markets developments and the accumulation of large amounts of unsustainable private debt were insufficiently addressed.

The thesis also finds indicators that the increasing intimacy between regulators and the financial sector could explain the regulatory regime. Given the opacity of lobbying, direct influence is difficult to prove. Yet, developments in the infrastructure of financial regulation legislative process in the EMU favoured the financial interest groups. Trusted as experts on regulatory issues and risk management, the financial industry was able to focus on substantial policy proposals in line with sector interest, instead of traditional lobby activities. The thesis finds a large degree of consistency between financial sector interests and regulatory legislation.

Thirdly, explanations to the regulatory regimes´ crisis prevention and crisis management arrangements can be found in institutional dynamics. The member states in the EMU are not a homogenous group. Diverging institutional economic structures reflects different financial systems, which in turn give rise to a variety of national regulatory preferences. Thus, intergovernmental negotiations characterise parts of policy-making on financial regulation and supervision. This has constrained agreements of macro-oriented, pan-European regulation and supervision.

In a similar fashion, the thesis finds some indications that diverging national economic structures can explain that some policy issues are more sensitive than others. Agreements on fiscal-burden sharing mechanisms, involves violation of member states sovereignty on taxation. Different welfare arrangements amongst EMU members, can constrain agreements on EU-level taxation that could be the basis for a crisis fund for transfers to countries or cross-border banks in trouble.

As stressed throughout the thesis, the explanatory variables (ideas, interests, institutions) are not to be viewed as competing explanations, but rather as complementary explanations. In addition their causal-paths are interlinked. Two linkages seem highly possible. First, the interaction between ideational and interest factors is mildly put, vivid. To separate the intellectual foundation of expert committees and the financial sectors´ view on the functioning of financial markets is not necessarily easy. For instance, neoclassical theory that emphasises free-market principles are likely to be in sync with large investment banks that favour lax regulation. For this reason it is hard to decide whether the consistency between early legislation drafts by the Commission and position papers by the industry are a result of industry lobbying or due to the belief system of expert committees and policy-makers. There is also a linkage between interests and institutional factors. The Lamfalussy framework formalized the consultation process between policy-makers and industry representatives. The new institutional arrangements strengthen the financial sectors ability to influence the policy-making process in Brussels.

The in-depth analysis of clearly defined causal mechanisms indicates the emphasis on internal validity in the research design. Although being a single-case study, an extreme such, theoretical implications should not be ruled out completely. The processes and causal mechanisms identified in this study are not necessarily unique to this case. Institutional arrangement that formalizes consultations between policy-makers and powerful organizations with private interests is likely to be a challenge to any democracy. Close

relationships between regulators and the regulated could be dangerous within any policy field. In the world of finance, were consumers suffer severe collective action problems, financial regulation is especially prone to well-organized and resourceful interest groups. Emphasis on interest groups "expert" advice when designing policy may lead to sector friendly regulations, but unfavourable outcomes for the society as a whole. Failing common democratic credentials, the interaction between policy-makers and financial sector representatives sorely needs more attention and should be given further emphasis within the field of political science.

The devastating financial turmoil of the past years has pervasively demonstrated the need for regulatory reform and predetermined crisis management procedures. Individual institutions risk management and market discipline should be a part of the future regulatory regime. However, macro prudential regulations should be included to address systemic risk adequately and make financial supervision more efficient. As financial crises have a tendency to reoccur, ex ante crisis management routines and legally-binding burden-sharing arrangements should be apart of policy reform in the Eurozone.

7 Literature

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